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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Docket No. EP 705

COMPETITION IN THE RAILROAD INDUSTRY

**INITIAL COMMENTS OF
THE ASSOCIATION OF AMERICAN RAILROADS**

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TABLE OF CONTENTS

I.	INTRODUCTION: THE POTENTIAL IMPACT AND NEGATIVE CONSEQUENCES OF ANY CHANGE IN ACCESS POLICY ARE FAR REACHING	1
II.	THE PUBLIC INTEREST REQUIRES THAT THE BOARD AVOID UNNECESSARY REGULATORY CHANGE THAT WOULD UNDERMINE REINVESTMENT AND NEW INVESTMENT OF PRIVATE CAPITAL IN THE NATION'S FREIGHT RAIL INFRASTRUCTURE.....	6
A.	The Staggers Act Objective of a Healthy and Viably Competitive Rail System Remains Relevant Today As the Freight Railroads Are Increasingly Called Upon to Help Meet the Nation's Economic, Environmental, and Resource Goals	6
B.	The Beneficial Effects of Continued Investment of Private Capital in the Freight Rail Network Are Undisputed	8
III.	THERE IS NO POLICY JUSTIFICATION FOR THE BOARD TO IMPOSE AN INVOLUNTARY ACCESS REGIME	12
A.	The Sound Regulatory Policies of the Post-Staggers Act Period Should Not Be Changed Without a Compelling Reason.....	13
B.	The Improved Financial Condition of Railroads Does Not Justify Change	16
C.	There Has Been No Reduction of Competition Among Railroads or Between Railroads and Other Modes, Much Less a Reduction that Would Warrant Changes to Current Policy	18
D.	There Has Been No Change in the Need for Railroads to Use Differential Pricing	22
IV.	THE EXISTING REGULATORY POLICIES ON ACCESS ADOPTED BY THE BOARD AND ITS PREDECESSOR HAVE PROPERLY IMPLEMENTED THE STATUTORY SCHEME AND HAVE SERVED THE PUBLIC INTEREST WELL.....	23
A.	The Competitive Access Rules Generally.....	24
1.	The Statutory Framework.....	24
2.	<i>Intramodal Rail Competition</i>	26
3.	<i>Midtec</i>	29
B.	Responses to the Board's Questions about Specific Statutory Provisions Underlying the Competitive Access Rules.....	32
1.	Reciprocal Switching	32
2.	Alternative Through Routes	33
3.	Definition of Terminal Facility	37
C.	The Board's Bottleneck Rules Are Sound and Constitute Established Law.....	38

1.	The Bottleneck Decisions.....	38
2.	Responses to the Board’s Questions Regarding Bottleneck Rates	42
D.	Access Pricing	43
V.	THE BOARD SHOULD AVOID A CHANGE IN REGULATORY POLICY THAT WOULD DISCOURAGE FUTURE INVESTMENT IN RAIL INFRASTRUCTURE AND THAT WOULD ADVERSELY AFFECT RAIL OPERATIONS AND SERVICE.....	45
A.	Involuntary Access Would Not Yield the Benefits of Market Based Competition.....	46
B.	Involuntary Access Would Undermine Railroads’ Ability to Earn Sufficient Returns on Their Capital Investments in Rail Assets to Attract New Capital.....	48
C.	Intrusive Regulation Would Adversely Affect Rail Operations, Resulting in Inefficiencies, Higher Costs and Diminished Quality of Rail Service	51
	CONCLUSION	53

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Pursuant to the Board's Notices dated January 11, 2011, and February 4, 2011, the Association of American Railroads ("AAR") respectfully submits its Initial Comments in the captioned proceeding. AAR is a trade association whose freight railroad members include all U.S. Class I railroads as well as approximately 75 U.S. short line and regional railroads and Amtrak. In 2010, AAR's member freight railroads handled 1.7 trillion ton-miles of freight and generated \$58 billion in revenues. AAR's members have approximately 170,000 employees. AAR's members have a vital interest in this proceeding, which directly implicates the sustainability of the freight rail industry.

AAR's Initial Comments are supported by the verified statements of Edward A. Burkhardt, William J. Rennie and Robert Willig, attached hereto.¹

I. INTRODUCTION: THE POTENTIAL IMPACT AND NEGATIVE CONSEQUENCES OF ANY CHANGE IN ACCESS POLICY ARE FAR REACHING

In this proceeding, the Board proposes "to explore the current state of competition in the railroad industry and possible policy alternatives to facilitate more competition, where appropriate." January 11, 2011 Notice at 1 ("STB Notice"). AAR understands the Board's

¹ Hereafter, these verified statements are referred to respectively as: "Burkhardt V.S.," "Rennie V.S.," and "Willig V.S."

inquiry to pertain principally, if not entirely, to policy alternatives that would require some form of involuntary access or interchange.

The Board's inquiry goes to the heart of rail industry economics and network operating efficiencies. It also shines a spotlight on the Board's regulatory oversight of freight railroads. The prospect of adopting "policy alternatives to facilitate more competition" raises the threat of missteps that could reverse the positive trends towards increased efficiency and financial stability that have characterized rail industry performance over the past 30 years. AAR and its members oppose any change in access policy by the Board because, as the record will show, there is no legal or factual basis for any change. It would be fundamentally unsound to weigh the industry down with unnecessary regulatory burdens at the very time when railroads are positioned to make a maximum contribution to the restoration of our Nation's economic health.

For 30 years, the Board and its predecessor the ICC have approached economic regulation of the freight rail industry in a manner that is consistent with the overarching policies of the Staggers Rail Act of 1980,² as reinforced and validated by ICC Termination Act of 1995.³ These policies hold that the regulator should not intervene in markets that are effectively competitive but should address abuses of market power if and when they arise.⁴ Thus, existing policy gives railroads the freedom to respond and adapt to competitive forces that exist in the

² Pub. L. 96-448, 94 Stat. 1895 (1980) ("Staggers Act").

³ Pub. L. No. 104-88, 109 Stat. 803 (1995) ("ICCTA").

⁴ "Congress believed that free competition for rail services would ensure that consumer demand dictated the optimal rate level, while facilitating enough long-term capital investment to maintain adequate service. Congress was also mindful, however, that the free market would protect consumers only if there was 'effective' competition. Therefore, the new enactments included provisions allowing regulatory intervention where competition would not control prices." *MidAmerican Energy Co. v. STB*, 169 F.3d 1099, 1105 (8th Cir. 1999) ("*MidAmerican*").

marketplace. The notion of “facilitating” competition involves disturbing the existing balance by trying to force additional competition through regulation rather than relying on market forces to the maximum extent as Congress directed.

The balanced approach to economic regulation that Congress chose and that has prevailed from 1980 up to the present has been widely regarded as fostering a rail renaissance. It has positioned the freight rail network to meet the Nation’s future transportation demands. “The Staggers Rail Act of 1980 partially deregulated the freight rail industry which led to dramatic productivity gains and improved efficiency in the freight rail network.”⁵ On multiple occasions, Congress has had before it proposed changes to the Staggers Act,⁶ and each time it has refused to undo the sound policies that led to a more efficient and financially sound railroad industry. Accordingly, the Board should not change its access policies that were carefully chosen to meet Congressional directives.

There is a significant likelihood that far reaching adverse effects would result from any modification of existing Board access policies. The mere threat of intensified regulatory

⁵ FED. R.R. ADMIN., DEP’T OF TRANSP., NATIONAL RAIL PLAN: MOVING FORWARD 15 (2010) (“2010 National Rail Plan”); *see also* Douglas W. Caves, Laurits R. Christensen & Joseph A. Swanson, *The Staggers Act, 30 Years Later*, 33 REGULATION 28, 30 (2010) (“As it turned out, the post-Staggers freight railroad industry has proven adept in providing new and more efficient services, and nimble in adjusting to changing commodity mixes through time.”).

⁶ A partial list of examples includes: Surface Transportation Board Reauthorization Act of 2011, S. 158, 112th Cong. (2011); Surface Transportation Board Reauthorization Act of 2009, S. 2889, 111th Cong. (2009); Railroad Competition and Service Improvement Act of 2007, H.R. 2125, 110th Cong. (2007); Railroad Competition and Service Improvement Act of 2007, S. 953, 110th Cong. (2007); Railroad Competition Act of 2006, S. 2921, 109th Cong. (2006); Railroad Competition Improvement and Reauthorization Act of 2005, H.R. 2047, 109th Cong. (2005); Railroad Competition Act of 2005, S. 919, 109th Cong. (2005); Surface Transportation Board Reform Act of 2003, H.R. 2192, 108th Cong. (2003); Surface Transportation Board Reform Act of 2001, H.R. 141, 107th Cong. (2001); Surface Transportation Board Modernization Act, H.R. 3398, 106th Cong. (1999); Railroad Shipper Protection Act of 1997, S. 1429, 105th Cong. (1997).

oversight can have a chilling effect on investment in rail infrastructure. Actual policy changes designed to impose rate reductions through artificial competition forced by regulatory fiat would negatively affect the level of railroad revenues and undermine the ability and incentive of railroads to replace existing rail infrastructure and to invest in new rail infrastructure. Involuntary access would pose major threats to the efficient operations of freight rail networks. Shipper-directed routing of traffic would lead to poorer service and higher operating costs and would undermine the ability of railroads to plan for the operation of and investment in their networks. Any changes to long-standing Board policies that pose threats of this nature should be avoided.

In its January 11, 2011 Notice initiating this proceeding, the Board identified a set of “events” that “taken together . . . suggest that it is time for the Board to consider the issues of competition and access further.” STB Notice at 3. Notably, however, “the improving economic health of the railroad industry, increased consolidation in the Class I railroad sector, the proliferation of a short line railroad network, and an increased participation of rail customers in car ownership and maintenance . . .,” *id.*, have not diminished competition in the surface transportation markets in which railroads compete.⁷ Furthermore, other factors cited by the Board such as diminishing productivity gains and rail rate increases in recent years do not signify that the competitive picture has changed for the worse. The definitive, objective study of rail competition undertaken by Christensen Associates at the Board’s request concluded that “[t]he

⁷ Moreover, with respect to rail consolidations, there has been no significant rail consolidation in the last ten years, and the Board itself has emphasized that in approving consolidations it took steps to assure that there would be no loss of rail-to-rail competition. *See Central Power & Light Co. v. S. Pac. Transp. Co.*, 1 S.T.B. 1059, 1071 n. 18 (1996) (“*Bottleneck I*”) (“when we found potential competitive harm, we mitigated it through our conditioning power”), *clarified*, *Central Power & Light Co. v. S. Pac. Transp. Co.*, 2 S.T.B. 235 (1997) (“*Bottleneck II*”), *aff’d sum nom. MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8th Cir. 1999); *see infra* section III.C (discussing rail mergers).

increase in railroad rates experienced in recent years is the result of declining productivity growth and increased costs rather than the increased exercise of market power.”⁸ And where market power exists and threatens economic efficiency, the Board already has the tools to address it.

The one notable change in the competitive landscape in recent years is that railroads are better equipped to compete vigorously with other modes, particularly against trucks, because they have the financial resources to do so. The availability of these resources is largely attributable to the ability of railroads to differentially price their services in response to shipper demand so as to earn revenues sufficient to maintain and, more critically, grow the rail network to meet future transportation needs. “Railroads use differential pricing to recover their total costs.” *Id.* Railroads must continue to be able to differentially price their services into the future. Any change in access policy that inhibited their ability to do so would be directly contrary to the public interest in a financially sound freight railroad network.

⁸ LAURITS R. CHRISTENSEN ASSOC., INC., A STUDY OF COMPETITION IN THE U.S. FREIGHT RAILROAD INDUS. & ANALYSIS OF PROPOSALS THAT MIGHT ENHANCE COMPETITION: REVISED FINAL REPORT ES-5 (2009) (“Christensen Study”). The railroad industry experienced dramatic productivity growth during the two decades immediately following passage of the Staggers Act as networks were rationalized and improved finances permitted efficiency-enhancing investments. Willig V.S., at 10-11. Productivity growth began to decline in the early 2000s as the readily available sources of productivity (*e.g.*, network rationalization) were largely exhausted.

II. THE PUBLIC INTEREST REQUIRES THAT THE BOARD AVOID UNNECESSARY REGULATORY CHANGE THAT WOULD UNDERMINE REINVESTMENT AND NEW INVESTMENT OF PRIVATE CAPITAL IN THE NATION'S FREIGHT RAIL INFRASTRUCTURE

A. The Staggers Act Objective of a Healthy and Viably Competitive Rail System Remains Relevant Today As the Freight Railroads Are Increasingly Called Upon to Help Meet the Nation's Economic, Environmental, and Resource Goals

The policy goal of achieving a financially sound and self-sustaining freight rail system was written into the Staggers Act with the hope of turning freight railroads into viable contributors to national economic growth instead of being financial drags on the economy.⁹ Over the course of the last 30 years that hope has been realized. Against the backdrop of a sound statutory framework (Staggers as modified by ICCTA) and generally sound regulatory policies implementing that framework, freight railroads have achieved a significantly improved level of financial stability and an enhanced ability to compete with other modes.

While the railroads have gradually improved their financial condition over the past 30 years, the U.S. role as the undisputed dominant player in the global economy has come under pressure. Corporate America, including many railroad customers, has responded effectively to the forces of globalization and maintains very strong financial profiles, but our Nation's overall financial performance vis-à-vis prior performance as measured by employment levels, income and other metrics continues to falter. Mainstreet America is struggling to shake off the lingering effects of the great recession and our Nation is faced with environmental and resource

⁹ "Almost all agree that something further must be done to improve the financial health of the nation's railroads or the industry will continue to falter with the likely alternative being only an increasingly heavy burden on the consumer and taxpayer. To the extent it remains desirable to continue private sector ownership of this nation's rail industry the need for this legislation is obvious and accepted. The goal is to allow for the restoration of the rail industry to vigorous and profitable growth." S. Rep. No. 96-470, at 6 (1979).

challenges. Freight railroads, which weighed down the economy pre-Staggers, are poised to help our Nation's economy thrive again.

The Board's overriding mandate is to regulate the railroad industry so as to promote the public interest expressed by Congress in a strong national freight rail system.¹⁰ Given the current state of affairs, the first priority for the Board should be to implement policies that will allow the railroads to fulfill their role as leading contributors to national economic growth and to maximize their role in meeting environmental and resource needs (such as reduced pollution, lower fuel use, and less highway congestion) and their ability to conduct efficient, safe operations.¹¹

Changes in access policy might be touted as a way to benefit a subset of shippers that hope to realize reduced rates through artificial competition. But any such benefits would come at the expense of not only the railroads, but also other shippers who use the rail network. As the Christensen Study concluded, "there is little room to provide significant 'rate relief' to certain groups of shippers without requiring increases in rates for other shippers or threatening the railroads' financial viability." Christensen Study at ES-39. Rather than pursuing changes in access policy that might allow for a small group of short term winners but would also assure the emergence of many more long-term losers, the Board should pursue policies that will promote

¹⁰ See 49 U.S.C. § 10101.

¹¹ The Federal Railroad Administration's recent progress report on the National Rail Plan "details the interplay of factors that demonstrate the importance of efficient and effective rail infrastructure to the Nation's economy. These include a dramatic increase in population, particularly in high-growth areas, and the concomitant need for transporting more freight and improving safety. Such an infrastructure will also reduce fuel consumption, which, in turn, will enhance our national security by diminishing our reliance on foreign oil." 2010 National Rail Plan at 3.

overall investment in and growth of the rail infrastructure, thereby allowing railroads to fulfill their role as engines of overall economic growth.¹²

B. The Beneficial Effects of Continued Investment of Private Capital in the Freight Rail Network Are Undisputed

A major contrast between U.S. rail infrastructure and the infrastructure that supports the operations of trucks, airlines, barges, and ocean vessels is that the construction and maintenance of rail infrastructure is supported by private capital. This in itself is a benefit to U.S. taxpayers, who do not have to sustain the burden of supporting capital investment in the railroad industry or fund the expenditures that would be needed to expand and maintain the highway system to accommodate the freight that currently moves on trains. While public/private partnerships involving rail infrastructure can make an important contribution in advancing societal goals, such as where freight rail provides a foundation for passenger rail without impairing the quality or growth of freight rail service, there is no doubt that private capital is the life blood of rail infrastructure investment that supports and will continue to support present and future rail freight operations in the private sector. Thus, the Board must be vigilant in pursuing policies that encourage the investment of private capital in an expanding freight transportation network.¹³

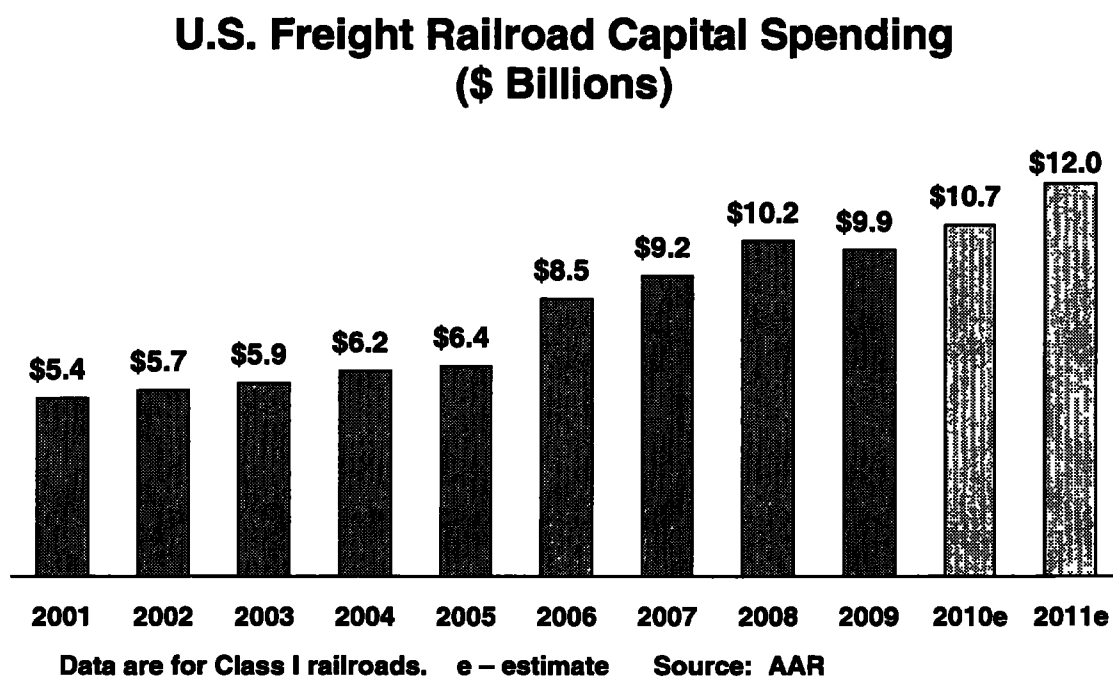
One such policy is continued support for differential pricing of rail services, which, as discussed

¹² Assuring a viable rail sector with capability to expand should be the highest of the Board's goals, both because it is mandated by statute, 49 U.S.C. § 10704(a)(2), and because achievement of the goal represents an optimal outcome, whereby many parties will be better off as a result of achieving the goal and none will be worse off. Conversely, forcing access where the market participants have not found it economically rational to provide access themselves will harm the greater public interest by discouraging investment and misallocating resources.

¹³ The need for an expanded network is unmistakable. USDOT/FHWA in their Freight Analysis Framework projection reports that between 2010 and 2040, the Nation's transportation system will experience a 61 percent increase in the amount of freight carried. Press Release, U.S. Dept. of Transp., DOT Releases New Freight Transportation Data (Nov. 3, 2010), *available at* <http://www.fhwa.dot.gov/pressroom/fhwa1062.htm>.

more fully in section III.D, is critical to enabling railroads to earn sufficient revenues to support capital investment.

In 2010, U.S. freight railroads spent an estimated record \$10.7 billion to build and expand their network infrastructure and purchase equipment. All of the major Class I railroads have announced planned capital spending programs in 2011 that will exceed capital expenditures in 2010. The combined projected capital expenditures of the major freight railroads for 2011 are \$12 billion. Josh Mitchell, *Investment to Rise in Freight Rail*, WALL ST. J., March 10, 2011. As indicated by the chart below, this \$12 billion in capital expenditures is more than double the \$5.4 billion in capital expenditures made by railroads just a decade ago in 2001.



The level of capital investment required to replace and expand rail freight infrastructure will increase in future years. The U.S. freight rail network already transports more ton-miles of goods than any other freight rail system in the world. 2010 National Rail Plan at 8-9. Increased

investment will be required to meet the needs of an expanding U.S. population. Private funding will be needed to support the following categories of capital projects in the coming decades:

- Large-scale corridor expansion projects;
- Bridge replacement;
- New intermodal terminals;
- More efficient locomotives and railcars;
- Upgrades to railway track and structures;
- Acquiring EPA Tier IV-compliant locomotives;
- New technology and communications systems, including those required to implement the unfunded federal mandate for Positive Train Control ("PTC").

Beyond the immediate objective of providing world class freight transportation, continued investment of private capital to replace existing facilities and expand rail capacity will contribute to U.S. economic growth in multiple ways. First, continued investment will create a stronger overall rail freight network that benefits all rail shippers and not just a subset of shippers that seek a revenue transfer to themselves through involuntary access.

Second, expansion of rail capacity will allow railroads to handle traffic that would otherwise move on over-crowded and under-maintained highways. Expansion of freight railroad capacity will serve the public interest by reducing highway congestion, the cost of repairs and the consumption of fossil fuels.

Third, private investments in railroads will be an engine for job creation. Railroads are already creating new jobs in the U.S. and will continue to do so into the future. In 2010, rail employment was up approximately 5.2 percent. ASS'N. OF AMERICAN RAILROADS, GREAT EXPECTATIONS 2011: FREIGHT RAIL'S ROLE IN U.S. ECONOMIC RECOVERY 10 (2011). The Class I railroads project that they will hire upwards of 10,000 workers in 2011, some to replace retirees

and fill positions lost through general attrition, while others will fill new jobs created to meet increased demand. *Id.* Longer term, railroads will need to hire to replace more than 67,000 employees, or roughly 30 percent of the rail workforce, who will be eligible to retire in the next five to 10 years, as well as additional workers needed to fill new jobs. *Id.*

Fourth, investment of private capital in the rail network will promote the competitiveness of U.S. industries in the global economy. “Improving freight rail’s intermodal market share and connections to ports supports the President’s National Export Initiative by enhancing the private sector’s ability to export.” 2010 National Rail Plan at 18. Rail dependent commodities like coal and grain are already moving in increasing volumes to U.S ports for export. Looking to the future, the Obama administration has established the goal of doubling U.S. exports, which will require freight rail to move even more goods to ports efficiently and cost-effectively in coming years. Rail capacity will need to grow to meet export demands, as well as to accommodate the already large volumes of intermodal traffic that constitutes consumer goods imported from overseas.

In short, there is a strong and broadly based public interest rationale for the Board to exercise its regulatory oversight of the rail industry in a manner that will promote the investment of private capital in the rail industry over the coming years so that the industry can realize its potential as a major contributor to the Nation’s overall economic well-being.¹⁴ Protecting parties against abuse of market power will remain an important element of the Board’s mission and the

¹⁴ *Rail Safety Improvement Act of 2008: Hearing Before the H. Transp. & Infrastructure Comm.*, 112th Cong. 7 (2011) (joint statement of Edward R. Hamberger, President, Association of American Railroads and Mark D. Manion, Exec. Vice President of Norfolk Southern Railway). The Board should also bear in mind that railroads have been required to invest their own capital in Positive Train Control technology, which will siphon off investment of some capital that would otherwise have been invested in projects to upgrade and expand rail infrastructure.

Board should continue to apply its access policy objectively and impartially. However, the Board should be careful to avoid any changes to its access policy that could compromise robust private investment in the rail network.

III. THERE IS NO POLICY JUSTIFICATION FOR THE BOARD TO IMPOSE AN INVOLUNTARY ACCESS REGIME

The Board's current approach to access regulation reflects a Congressionally mandated balance between the promotion of market forces in transportation markets and the protection against abuses of market power. Thus, the Board allows markets in which there is no abuse of market power to function without regulatory interference so that resources and services can be allocated most efficiently. At the same time, the Board continues to address abuses of market power if and when they arise where there is no effective competition. The Board's balanced approach has produced clear benefits for railroads, their shippers and the U.S. economy in general. Where regulatory policies are effective, there must be a compelling reason to change them.

Nothing has occurred since the ICC adopted the *Intramodal Rail Competition*¹⁵ rules that would justify a fundamental change in the Board's current balanced approach to access policy. The parochial interests of some shippers in obtaining a revenue transfer from the railroads to those shippers cannot justify a change in regulation that could affect the ability of freight railroads to meet safely and efficiently the Nation's future economic, environmental and resource goals. Those who would advocate giving further consideration to a changed regulatory approach must be able to show initially that a change in access policy would produce net public benefits, rather than benefits only to themselves, that would significantly exceed the potential harm that

¹⁵ 1 I.C.C.2d 822 (1985), *aff'd sub nom. Baltimore Gas & Elec. v. United States*, 817 F.2d 108 (D.C. Cir. 1987). These rules appear in the Board's regulations at 49 C.F.R. § 1144.2.

could result. The Board should not consider changing its current access policy unless such a showing is made by the proponents of change.

A. The Sound Regulatory Policies of the Post-Staggers Act Period Should Not Be Changed Without a Compelling Reason

The existing regulatory policies regarding access that the ICC and the Board have adhered to for 30 years have worked well. Under the current balanced approach to access regulation, railroads have been able to make economically rational decisions about the use of their assets. The Board's regulatory policies have given railroads the incentive to invest in capacity expansions and infrastructure improvements, resulting in an efficient freight rail network that serves the interests of the shipper community and the economy in general. It is widely acknowledged that the U.S. freight rail system is the best in the world. *Rennicke V.S.* at 3-7.

To date, the principal tangible benefit that shipper advocates of involuntary access have identified is reduced rail rates for some subset of movements, *i.e.* a revenue transfer from the freight railroads to select shippers. But the shippers already have adequate regulatory remedies in cases where they believe a railroad's rates are too high under the stand-alone cost ("SAC") test or the standards adopted by the Board in *Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No. 1) (served Sept. 5, 2007) ("*Simplified Standards*").¹⁶ The advocates of involuntary access cannot explain why shippers should be entitled to pursue rate reductions through expanded access regulation when rate reasonableness remedies are readily available.

¹⁶ To the extent a shipper has a concern about the abuse of market power unrelated to rate levels, they can address those concerns under the Board's Competitive Access Rules. The legal framework of the Competitive Access Rules is discussed below in Section IV. As explained below, the courts have made it clear that the Competitive Access Rules are not "intended to be an alternative means of obtaining rate relief." *Midtec Paper Corp. v. United States*, 857 F.2d 1487, 1505 (D.C. Cir. 1988) ("*Midtec*").

Indeed, over the past several years, the Board has worked hard to make it easier for shippers to challenge the reasonableness of rail rates. In 1998, the Board responded to concerns that the complexity of market dominance evidence was discouraging shippers from bringing rate reasonableness challenges, and the Board modified its market dominance rules to eliminate evidence relating to product and geographic competition. *Market Dominance Determinations – Product and Geographic Competition*, 3 S.T.B. 937, remanded sub nom. *Ass’n. of Amer. Railroads v. STB*, 237 F.3d 676 (D.C. Cir. 2001) (“1998 Market Dominance Decision”). After changing the market dominance rules, the Board experienced a sharp increase in rate reasonableness litigation in the early 2000s. Beginning in 2005, the Board held a series of hearings on the stand-alone cost methodology focused on ways to streamline large rate case litigation, resulting in the decision in *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (served Oct. 30, 2006). In 2007, the Board adopted *Simplified Standards*, which established two alternative simplified methodologies for assessing the reasonableness of rates in smaller cases.

While AAR’s members do not agree with every aspect of the Board’s current rate regulation standards and procedures, there is no doubt that the SAC test and the procedures set out in *Simplified Standards* provide the remedies that shippers are entitled to under the statute. Furthermore, shippers benefit from the existence of the Board’s rate regulation remedies even without initiating a rate case. The Christensen Study found that railroad pricing is “tempered by the prospect that large markups may elicit regulatory attention if not direct intervention. That is, monopoly railroads may effectively cede some market power to avoid regulatory scrutiny.” Christensen Study at ES-26.

Involuntary access is not being sought as protection against the abuse of market power. Shippers already have adequate remedies to address unreasonable rates that result from an exercise of market power, and the existing competitive access regulations protect against other abuses of market power that would be manifested in inadequate service or anticompetitive practices. Rather, involuntary access is being sought as a means to redistribute revenues from the railroads to a subset of shippers. But the advocates of involuntary access have not shown that there would be any public benefits, or benefits to shippers as a whole, from the revenue transfer from railroads to individual shippers that some seek through enhanced access regulation. While some individual shippers could see their rail transportation costs reduced in the short term, the resulting revenue transfer would adversely affect the broader public interest by draining away revenues that railroads need to invest in or maintain the rail infrastructure that supports achievement of the Nation's economic, resource, and environmental goals.

Moreover, as discussed more fully in Section V below, unnecessary additional regulation imposes social costs by distorting markets, which is why it is a goal of rail transportation policy "to minimize the need for Federal regulatory control over the rail transportation system. . . ." 49 U.S.C. § 10101(2). As Professor Robert Willig explains in the accompanying verified statement, unnecessary regulation distorts investment incentives and interferes with the price levels that are necessary for efficient resource allocation. Willig V.S. at 3. In addition, involuntary access would lead to a more balkanized rail network that would create operational inefficiencies and have an adverse impact on service and the cost of providing that service.

In this proceeding, the burden is on proponents of change to demonstrate concrete benefits that would flow from any further consideration of changing current policies regarding artificial competition – benefits that outweigh the costs identified above. The Board said as

much in its Notice when it stated that “[a]ny party advocating a change [in access policy] should address the impacts” of a policy change. STB Notice at 7.

B. The Improved Financial Condition of Railroads Does Not Justify Change

The suggestion that the improved financial health of the railroad industry justifies pursuing new regulatory policies that could jeopardize that health is inherently flawed. If railroads have achieved a state of relative financial health, the goal of the regulator responsible for their economic oversight should be to foster conditions that will sustain that health and not to pursue steps that might jeopardize it.

Congress did not expect or authorize the Board to abandon the strong deregulation policies of the Staggers Act once railroads achieved financial stability. Indeed, when Congress adopted ICCTA, it noted the positive changes in railroads’ financial health that had already been brought about by the Staggers Act: “The Staggers Act has produced a renaissance in the railroad industry. . . ,” H.R. Rep. No. 104-311, at 91 (1995), and has “result[ed] in the restoration of financial health to the rail industry.” S. Rep. No. 104-176, at 3 (1995). But Congress did not back away from its strong deregulation policy in light of the improved financial health of the industry. To the contrary, Congress enacted ICCTA expressly to “continue[] the deregulation theme of the past 15 years by providing further regulatory reductions in the surface transportation industries.” S. Rep. No. 104-176, at 5 (1995).

The suggestion that improved financial performance of the railroad industry justifies new regulation also raises the question of why, as a logical matter, the overall financial performance of the railroad industry should have any influence on the Board’s approach to access regulation. There is no nexus between the overall financial health of a railroad and the need to grant access to a second carrier at a particular location on a railroad’s network. Involuntary access remedies are intended to address the circumstances of particular shippers at particular locations where

competition is not effective and where the affected shipper cannot be protected adequately by rate regulation. A railroad's overall financial health has no bearing on whether these preconditions that could justify an involuntary access remedy for a particular shipper exist. Involuntary access should not be imposed as a penalty on railroads for managing to become self-sustaining, profitable enterprises.

In any event, advocates of involuntary access cannot show that railroad earnings have reached the level that would sustain the railroad industry over the long term and guarantee the replacement of assets. AAR strongly believes that the correct measure of revenue adequacy is that a railroad should be able to earn its cost of capital on a properly defined asset base. Particularly in an industry like the railroad industry that has long-lived assets, the use of depreciated book value to measure the adequacy of revenues, as the Board does in its current annual revenue adequacy determinations, understates revenue needs. In 2008, AAR requested that the Board consider adopting a new replacement-cost methodology to determine revenue adequacy on an annual basis. The Board declined to pursue AAR's request out of a concern over the practical difficulties of implementing such an approach in the context of its annual determinations, but it did not question AAR's premise that a replacement-cost approach, if it could be implemented, would be a better means of determining whether railroads were earning enough to sustain themselves over the long-term. *See Ass'n. of Am. Railroads – Petition Regarding Methodology for Determining Railroad Revenue Adequacy*, Ex Parte No. 679 (served Oct. 24, 2008).

The alternative studies of railroad financial performance referred to in the STB Notice do not purport to examine whether railroads have achieved sustained earnings sufficient to guarantee the replacement of the substantial infrastructure needed to provide effective and

efficient rail service. The Christensen Study commissioned by the Board looked at railroads' average total costs and, like the Board's current revenue adequacy approach, did not consider replacement costs.¹⁷ The recent report by the United States Departments of Agriculture and Transportation addressed railroads' financial condition using a variety of measures that say nothing about the ability of the railroads to sustain themselves over the long term.¹⁸

C. There Has Been No Reduction of Competition Among Railroads or Between Railroads and Other Modes, Much Less a Reduction that Would Warrant Changes to Current Policy

Most surface transportation markets in which railroads are present are effectively competitive. Railroads face widespread competition from trucks, barges and other railroads, as well as from source (geographic) and product competition. The intensity of competition has not diminished in recent years.

Truck competition remains strong. As discussed in the recent hearing on exemptions – *Review of Commodity, Boxcar, and TOFC/COFC Exemptions*, STB Docket No. EP 704 (hearing held Feb. 24, 2011) – trucks are viable competitors for most traffic handled by railroads. The range of service options and flexibility offered by trucks make them the preferred competitive option for short-haul movements. Witnesses at the exemption hearing explained that even on long-haul movements, trucks compete vigorously with railroads. *See also* Christensen Study at 15-1 (discussing extensive truck competition in the intermodal market).

¹⁷ The Christensen Study "revenue sufficiency" approach also had a number of other serious shortcomings, including the fact that it ignored the obligation to pay income taxes and compared pre-tax revenues to after-tax cost-of-capital.

¹⁸ *See* STUDY ON RURAL TRANSPORTATION ISSUES, at 265-66 (2010) ("USDA/DOT Study"). The USDA/DOT Study also misstated the conclusions reached in the Christensen Study and claimed, incorrectly, that the Christensen Study "found that the Class I railroads could be considered revenue adequate since 2001." *Id.* at 264. In fact, the Christensen Study concluded that "the industry has remained close to being revenue adequate for most years in our study, but more often than not it has fallen short." Christensen Study at ES-20.

Rail-to-rail competition also remains strong, although it does not exist for all rail movements and never has. Some have suggested that the reduction in the number of Class I railroads since 1980 has resulted in a lessening of intramodal competition.¹⁹ But the data cited by these critics of rail mergers is misleading because, among other things, it includes in the count of Class I railroads in 1980 a number of railroads that were already in dire financial condition and railroads that had already been merged into other railroads.²⁰ And while there has been a decline in the number of Class I railroads since 1980, there has also been a substantial overall increase in the total number of railroads, as the Christensen Study found. Christensen Study at ES-8 (“the total number of railroads has increased from about 490 in the mid-1980s to the current 559”).

Of greater importance, the ICC and the Board have been careful over the years to ensure that there has been no diminution of rail-to-rail competition as a result of the Class I rail mergers that occurred after the Staggers Act. As the Department of Transportation observed in comments to the Board regarding the history of the Staggers Act, “although there certainly have been a large, large number of mergers,” in each case the agency imposed conditions that “sought to

¹⁹ See, e.g., *Review of Commodity, Boxcar and TOFC/COFC Exemptions*, STB Docket No. EP 704 (written testimony of National Industrial Transportation League at 16) (submitted Jan. 31, 2011).

²⁰ For example, the Chicago, Milwaukee, St. Paul & Pacific R.R. Co. and the Chicago, Rock Island & Pacific Railroad, two Class I railroads in 1980, were bankrupt and were undergoing full or partial liquidation in 1980. Twelve railroads listed as Class I railroads in 1980 had already been merged into other Class I railroads. For example, the Baltimore & Ohio Railroad Co. had been a subsidiary of Chesapeake & Ohio since 1963, and the Colorado & Southern Railway Co. had been a subsidiary of Burlington Northern Inc. or its predecessor, Chicago, Burlington & Quincy, since 1908. One company considered Class I in 1980, Long Island Railroad, was and remains today, almost exclusively a passenger carrier. Moreover, the revenue threshold that defines Class I railroads has changed since 1980. Even adjusting for inflation, under current threshold standards, there would have been only 18 fully functioning Class I freight railroads in 1980.

ensure that no rail shipper that was [served by] at least two carriers received less than that.”

DOT was “not aware of any merger related gain in the number of captive shippers.” Transcript of Hearing at 22-23, *The 25th Anniversary of the Staggers Rail Act of 1980: A Review and Look Ahead*, STB Ex Parte No. 658 (Oct. 19, 2005) (remarks of Paul Samuel Smith). The Board itself has similarly rejected shipper claims that rail mergers reduced shippers’ competitive options, saying that “when we found potential competitive harm [from a proposed rail merger], we mitigated it through our conditioning power.” *Bottleneck I*, 1 S.T.B. at 1071 n.18.

Similarly, there has been no diminution of product and geographic competition in rail markets in recent years. The Board and ICC have repeatedly recognized that product and geographic competition can provide powerful constraints on rail pricing. While the Board decided in 1998 to eliminate evidence of product and geographic competition from market dominance determinations in rate proceedings for practical reasons, the Board recognized that those competitive forces often effectively constrain rail pricing. “We have no doubt that in certain circumstances product and geographic competition effectively limit railroad pricing.”²¹ Indeed, product and geographic competition remain relevant when examining whether the Board is required to exempt certain traffic from regulation under 49 U.S.C. § 10502.

Trends in rail rates over the past decade provide no evidence of a reduction in competition. The Christensen Study undertook a careful review of rail rate trends and expressly concluded that recent rate trends provided no evidence of an increase in the exercise of market power by railroads. The study observed that after a long period of rate decreases after the

²¹ *1998 Market Dominance Decision*, 3 S.T.B. at 946 n.49; *see also Market Dominance Determinations – Product and Geographic Competition*, 5 S.T.B. 492, 493, *petition for review denied sub nom. Ass’n. of Amer. Railroads v. STB*, 306 F.3d 1108 (D.C. Cir. 2002) (noting that product and geographic competition “can provide effective alternatives that may be sufficient to constrain a rail rate to a reasonable level.”).

Staggers Act, “since the early 2000s, rates generally began to go up, creating questions about the exercise of market power in the increasingly concentrated railroad industry. Much of the observed increase in rail rates can be explained by examining railroad industry input prices and productivity growth.” Christensen Study at ES-16 (note omitted). The study specifically found that “[t]he increase in railroad rates experienced in recent years is the result of declining productivity growth and increased costs rather than the increased exercise of market power.” *Id.* at ES-5. In their January 2010 Update, Christensen Associates concluded that since “marginal cost has been increasing at a faster average annual rate than railroad revenue per ton-mile . . . the measure of railroad market power has been *decreasing*.”²²

Competitive options for many shippers have actually increased as a result of recent railroad investments that have been facilitated by the current regulatory policies. For example, substantial investments have been made by railroads in transload facilities and intermodal terminal facilities that have expanded access to multiple rail options for many carload shippers that were once limited to direct rail service by a single carrier. Transload facilities permit traffic to be trucked a short distance before being loaded into rail cars of a rail carrier that does not directly access the shipper’s facility. The use of intermodal service, with truck origination and delivery, has given many boxcar shippers who had limited rail options in the past the opportunity to ship containerized freight via multiple rail carriers. Thus, contrary to the claims of some advocates of involuntary access, competition in the railroad industry has increased precisely because the Board has allowed markets to function without unnecessary regulatory interference.

²² LAURITS R. CHRISTENSEN ASSOC., INC., AN UPDATE TO THE STUDY OF COMPETITION IN THE U.S. FREIGHT RAILROAD INDUSTRY: FINAL REPORT i (2010) (“Christensen Update”) (emphasis added).

D. There Has Been No Change in the Need for Railroads to Use Differential Pricing

Congress, the ICC and the Board have all recognized that rail carriers face a broad range of competition for their services in the many different markets in which they operate. These varying competitive circumstances range from intense rail-to-rail, rail-to-truck and rail-to-water competition, as well as product and geographic competition in many markets; to less intense but still vigorous competition; to situations in which railroads are market dominant. The ability to set prices relative to the varying shipper demand for rail service experienced in different markets is critical to the long-term viability of the railroad industry.

When it issued the *Coal Rate Guidelines*, the ICC recognized that “the cost structure of the industry necessitates differential pricing of rail services.” *Coal Rate Guidelines Nationwide*, 1 I.C.C.2d 520, 526 (1985), *aff’d sub nom. Consol. Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987). Railroads’ high fixed costs and substantial economies of density require that railroads be permitted to set prices based on shippers’ relative demand for service. As the ICC explained, if railroads could not set demand-based prices, they would lose traffic from shippers with competitive options, leaving the remaining shippers to pay a higher portion of the railroad’s fixed costs. Nothing has changed in the underlying economics of the railroad industry that diminishes the importance of differential pricing.

The Christensen studies recognized that railroads cannot recover their costs through marginal cost pricing and that differential pricing is necessary for full cost recovery in the rail industry. *See, e.g.,* Christensen Update at 4-7. By prohibiting railroads from using complainant-shippers’ traffic to cross-subsidize other parts of their systems, the Board’s rate reasonableness standards ensure that railroads do not earn monopoly profits. The existing regulatory scheme

thus permits railroads to engage in differential pricing, which is necessary for them to earn revenues sufficient to sustain themselves over the long term.

Shippers who advocate involuntary access as a means of achieving rate compression are unable to identify any approach to railroad pricing other than differential pricing that could provide sustained railroad financial viability into the future. That is because there is none. The need to adhere to differential pricing going forward is a principal consideration weighing against any change in access policy.

IV. THE EXISTING REGULATORY POLICIES ON ACCESS ADOPTED BY THE BOARD AND ITS PREDECESSOR HAVE PROPERLY IMPLEMENTED THE STATUTORY SCHEME AND HAVE SERVED THE PUBLIC INTEREST WELL

The Board's existing competition policies implement multiple aspects of rail transportation policy adopted in the Staggers Act and carried forward in ICCTA. The broad policy goals most relevant to access policy are:

- "to allow, to the maximum extent possible, competition and the demand for service to establish reasonable rates for transportation by rail;"
- "to minimize the need for Federal regulatory control over the rail transportation system;"
- "to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Board;"
- "to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital;"
- "to prohibit predatory pricing and practices, to avoid undue concentrations of market power, and to prohibit unlawful discrimination."²³

From the enactment of Staggers onward, the agency has sought to balance and harmonize these broad policy goals. In doing so, the ICC and the Board have been guided both by the

²³ 49 U.S.C. § 10101(1), (2), (3), (6), (12).

policy goals themselves and by the various statutory provisions that provide more precise directives for the implementation of access policy. The balance generally has been to permit maximum reliance on market forces to secure competitive outcomes, limiting agency intervention to relatively rare instances of market power abuse.

As discussed below, the specific access policies adopted by the ICC and the Board have been consistently affirmed and endorsed by reviewing courts as consistent with both the overriding Congressional goals and specific statutory provisions of Staggers and ICCTA. In particular, three appellate court decisions – *Baltimore Gas & Electric*,²⁴ *Midtec*, and *MidAmerican* – define the current contours of competitive access law, which should not be changed absent a clear directive from Congress.

A. The Competitive Access Rules Generally

1. The Statutory Framework

Two statutory provisions fall expressly within the ambit of the Board's Competitive Access Rules, first adopted by the ICC in *Intramodal Rail Competition*. Prescription of through routes under 49 U.S.C. § 10705 and reciprocal switching under 49 U.S.C. § 11102(c) are expressly covered by the Competitive Access Rules. See 49 C.F.R. § 1144.2. Although not expressly covered by the rules, prescribed access to terminal facilities under 49 U.S.C. § 11102(a) has been construed by the ICC and Board as calling for essentially the same analysis.²⁵

²⁴ *Baltimore Gas & Elec. v. United States*, 817 F.2d 108 (D.C. Cir. 1987) ("*Baltimore Gas & Electric*").

²⁵ The ICC did not originally include terminal access under the Competitive Access Rules because it anticipated that "joint rates, through routes, and reciprocal switching mechanisms should be sufficient to provide shippers and carriers with ample competitive access where necessary." *Intramodal Rail Competition*, 1 I.C.C. 2d at 835. The ICC subsequently determined, however, that because "the underlying public interest test" was the same as for reciprocal switching, and "given the relationship between the issues and the remedies, we believe that the public interest analysis should be similar." *Midtec Paper Corp. v. Chicago & North Western*

The Board may prescribe through routes “when it considers it desirable in the public interest.” 49 U.S.C. § 10705(a)(1). The Board may “require a rail carrier to include in a through route substantially less than the entire length of its railroad” only when: “required under section 10741, 10742, or 11102;” “inclusion of those lines would make the through route unreasonably long when compared with a practicable alternative through route that could be established;” or “the Board decides that the proposed through route is needed to provide adequate, and more efficient or economic, transportation.” 49 U.S.C. §§ 10705(a)(2)(A)-(C).

The Board may order reciprocal switching “where it finds such agreements to be practicable and in the public interest, or where such agreements are necessary to provide competitive rail service.” 49 U.S.C. § 11102(c)(1) (2010). And the Board may grant access to terminal facilities “if the Board finds that use to be practicable and in the public interest without substantially impairing the ability of the rail carrier owning the facilities or entitled to use the facilities to handle its own business.” 49 U.S.C. § 11102(a).

Consistent with Staggers, the ICC read these provisions narrowly in *Intramodal Rail Competition* as providing remedies for competitive abuse and not as invitations to create competition through regulatory intervention. As a result, competitive access remedies are the exception and not the rule. Access is granted only upon a showing that a carrier has abused its market power either by extracting unreasonable terms or by rendering inadequate service. *See Midtec*, 3 I.C.C. 2d at 181; *Review of Rail Access and Competition Issues*, 3 S.T.B. 92, 98 (1998). Congress, the ICC, and the Board have all recognized that market power abuse can be manifested in ways other than high rates. The competitive access remedies adopted by the Board and the ICC are, consistent with the statute and Congress’ intent, designed to address conduct-

Transp. Co., 3 I.C.C. 2d 171, 178 (1986), *aff’d sub nom. Midtec Paper Corp. v. United States*, 857 F.2d 1487 (D.C. Cir. 1988).

based abuses of market power that cannot be reached through regulation of unreasonable rates. They are a complement to rate reasonableness regulation that provide a structural remedy to market power abuse that is not remediable through the less intrusive (and less market distorting) mechanism of rate relief.

2. *Intramodal Rail Competition*

Under the long-standing rules established in *Intramodal Rail Competition* five years after Stagers, reciprocal switching and prescription of alternative through routes are available only when “necessary to remedy or prevent an act that is contrary to the competition policies of 49 U.S.C. § 10101a [now § 10101] or is otherwise anticompetitive.” *Intramodal Rail Competition*, 1 I.C.C. 2d at 841. The Competitive Access Rules were affirmed and embraced by the D.C. Circuit in a pair of decisions. The first, *Baltimore Gas & Electric*, was an appeal directly from *Intramodal Rail Competition*. The second, *Midtec*, was an appeal arising from the first application of the rules. These decisions confirm that the Competitive Access Rules were soundly grounded in the statutory changes made by the Railroad Revitalization and Regulatory Reform Act²⁶ in 1976 and, more emphatically, by the Stagers Act just four years later. As recognized by the D.C. Circuit in these decisions, the ICC clearly understood that decades of misguided regulation had brought the railroads to the brink of financial ruin, that Congress had taken steps to correct past regulatory missteps, and that its new rules must foster rather than hamper the changes in the industry necessary to ensure a sound railroad transportation system.

On appeal from *Intramodal Rail Competition*, the shipper interests in *Baltimore Gas & Electric* challenged the Competitive Access Rules, arguing that the narrow remedial provisions adopted by the ICC should be recast as much broader permissive measures that would result in a

²⁶ Pub L. No. 94-210, 90 Stat. 31 (1976) (“4R Act”).

grant of competitive access wherever such access would be beneficial to shippers. The Court firmly rejected the shippers' construction of the relevant statutory provisions and underlying policies. In reaching its conclusions, the Court first examined the industry structure that had come to exist under the prior regulatory regime. The Court noted that, "[b]y the mid-1970s, the railroad industry had evolved into a system characterized by 'open routing' and 'rate equalization'" under which "through routes were created on practically all possible combinations of railroad tracks between two points" and "all routes between the same two points – including single line routes – were offered to shippers at the exact same rates, without regard to the actual cost of providing the service." *Baltimore Gas & Elec.*, 817 F.2d at 110. The defects in this regime were obvious: railroads were prohibited from responding to market forces by competing with one another or with other modes of transportation; cost recovery and efficient routings were ignored. As the Court explained, the prior approach to regulation "forced certain shippers to pay rates that were higher than might have prevailed in a competitive environment; in order to 'cross subsidize' artificially low rates charged other shippers." *Id.* at 111. Railroads could not price to the market. "Railroads with more efficient routing were typically prevented from offering lower rates, which retarded the industry's ability to compete with other modes of transportation such as trucks, barges and pipelines." *Id.* In many cases, railroads forced to participate in joint routes were unable to raise rates so that their share would even cover costs, much less reflect market forces. "This of course reduced their ability to attract capital needed to maintain and revitalize existing facilities." *Id.* Facing "what amounted to an overall financial crisis in the railroad industry," *id.*, Congress acted to cut back the ICC's authority to maintain the open routing system, first in the 4R Act and then further reducing it in Staggers. *Id.* at 112-13.

Having addressed the circumstances that gave rise to the new statutory scheme underlying the ICC's Competitive Access Rules, the Court turned to the shippers' claims on appeal, which it characterized as a broad effort to obtain open access to rail facilities akin to the access initiatives that arose in the telecommunications industry as a result of the AT&T antitrust settlement. *Baltimore Gas & Elec.*, 817 F.2d at 114. The court noted the shippers' argument that "[c]ompetition would most efficiently influence rates . . . if all railroads could, by way of through routes, benefit from all of each other's tracks and facilities." *Id.* at 114-15. Elaborating, the court explained that

BG&E's position, as we understand it, is that recent rail legislation requires the ICC to regulate the railroad industry along the lines of the telecommunications industry. . . . Under the AT&T antitrust suit settlement, local Bell telephone companies are required to permit all long distance telephone companies equal access to the lines and switching facilities necessary to reach local customers.

Id. at 115. The Court understood the shippers to be requesting that it "direct the ICC to return essentially to its old regulatory regime, by prescribing through routes on all possible combinations of tracks between all points." *Id.* at 114.

The Court categorically rejected the shippers' construction of the statute, concluding that it saw "not the slightest indication that Congress intended to mandate a radical restructuring of the railroad regulatory scheme so as to parallel [the open access regime of] telecommunications regulation." *Id.* at 115. The Court observed that the ICC had served a number of purposes set out in the National Rail Transportation Policy. The ICC had assisted "railroads' efforts to earn adequate revenues," by making it easier for railroads "to avoid participation in unremunerative and inefficient through routes." *Id.* At the same time, the ICC had recognized that "the needs of the railroads are not the sole consideration." The Court concluded:

The regulations take into account shippers' interests in reasonable rates, *see* 49 U.S.C. §§ 10101a(1) and (6) (1982), by, for example,

requiring the ICC to set aside through route cancellations that are 'anticompetitive.' They also reflect the Staggers Act's strong emphasis on preserving and enhancing competition, *see* 49 U.S.C. §§ 10101a(1), (4) and (5) (1982), and at the same time restrict the circumstances under which the ICC will exercise its power to require through rates, thereby limiting federal regulatory control over the industry, *see* 49 U.S.C. § 10101a(2) 1982.

Id.

3. *Midtec*

The D.C. Circuit's subsequent decision in *Midtec*, affirming the ICC's first application of the Competitive Access Rules, struck many of the same themes. The *Midtec* Court addressed similarly broad claims that competitive access should be freely ordered. In *Midtec*, the complainants sought both reciprocal switching and terminal access. After confirming that the ICC's decision to evaluate both forms of access under the same standard was "strongly supported by the Conference Report on the Staggers Act," *Midtec*, 857 F.2d at 1502, the Court addressed *Midtec*'s assertion that terminal access and reciprocal switching "were intended by the Congress to increase interrail competition in order 'to offset the very substantial rate advantages given the railroads' under other provisions of the Staggers Act." *Id.* at 1505. The Court expressly rejected *Midtec*'s argument that these forms of competitive access were "intended to be an alternative means of obtaining rate relief, requiring the Commission affirmatively to move the national rail system toward a regime more like perfect competition, with the attendant benefits of marginal cost ratemaking," finding that reading of the statute "inconsistent with Congress's intent to deregulate railroad ratemaking in the absence of a market dominant carrier." *Id.* at 1505-06. As the Court observed, "if the Commission were authorized . . . to prescribe reciprocal switching or terminal trackage whenever such an order could enhance competition between rail carriers, it could radically restructure the railroad industry." *Id.* at 1507. Of particular relevance to the current proceeding, the *Midtec* Court observed that "competition policy is not a matter of

regulators handicapping would-be competitors in order to create an evenly matched contest.” *Id.* at 1503.

In this proceeding, the Board has invited parties to comment on how the statutory competitive access provisions (§10705, §11102(a), §11102(c)) should be construed in light of “current transportation market conditions.” STB Notice at 6. The short answer is that there is nothing in “current transportation market conditions” that could justify changes to the long-standing interpretation of the statute or the Board’s Competitive Access Rules. To the contrary, it is clear that the existing regulatory policies, introduced to comply with the Staggers Act, and reinforced by ICCTA, must be continued if the goal is to retain a financially viable, competitive rail industry. The regulatory policies adopted post-Staggers have broadly achieved what was desired: an efficient, rationalized rail network where pricing and output decisions are determined by market forces and where most of the traffic has effective competition options. It would be nonsensical to conclude that because the rail industry is now largely shaped by market forces, as Staggers sought, it is time to adopt a different statutory interpretation to facilitate a radical restructuring of the industry in a manner that replaces market forces with judgments by regulators about how they believe the industry should function.

Moreover, the D.C. Circuit decisions in *Baltimore Gas & Electric* and *Midtec*, discussed above, make it clear that there are statutory constraints on the ability of the Board to adopt a new approach to granting competitive access that would turn the clock back in the direction of the pre-Staggers era. The Court that reviewed the Competitive Access Rules emphasized that there was “not the slightest indication that Congress intended to mandate a radical restructuring of the railroad industry.” *Baltimore Gas & Elec.*, 817 F.2d at 115; *see also Midtec*, 857 F.2d at 1507 (ICC could not “prescribe reciprocal switching or terminal trackage whenever such an order

could enhance competition” because it had not been granted authority to “radically restructure the railroad industry”). Key elements of the National Rail Transportation policy also limit any new interpretation that would hearken back to a prior era, including goals that market forces should determine rates “to the maximum extent possible,” 49 U.S.C. § 10101(1), “to minimize the need for Federal regulatory control over the rail transportation system,” 49 U.S.C. § 10101(2), and “to foster sound economic conditions in transportation and to ensure effective competition and coordination between rail carriers and other modes,” 49 U.S.C. § 10101(5), as does the Board’s obligation to “make an adequate and continuing effort to assist” carriers in achieving adequate revenues. 49 U.S.C. § 10704(a)(2) (2010).

In sum, the Competitive Access Rules have been in place since 1985, and, pursuant to *Baltimore Gas & Electric* and *Midtec*, their soundness and consistency with Staggers Act provisions and policies are well-established. Further, in the quarter-century since, Congress has remained well aware of the rules and has chosen not to change them through legislation. Indeed, during the course of the last Congressional overhaul of rail regulation which culminated in ICCTA, numerous shippers asked Congress to revise the statute to eliminate the Competitive Access Rules and permit some form of open access.²⁷ Congress declined to do so then, and has not done so since. In these circumstances, the Board should not modify these well-settled rules absent Congressional direction. *Cf. Bob Jones Univ. v. United States*, 461 U.S. 574, 601 (1983) (finding Congress’s refusal to reverse IRS decision despite full awareness of the decision,

²⁷ See, e.g., *Future of Rail Regulation: Hearing Before the Subcomm. on Railroads, Pipelines and Hazardous Materials of the H. Transp. & Infrastructure Comm.*, 104th Cong. 8-9 (1995) (statement of the Society of Plastics Industry Inc.); *Future of Rail Regulation: Hearing Before the Subcomm. on Railroads, Pipelines and Hazardous Materials of the H. Transp. & Infrastructure Comm.*, 104th Cong. 6 (1995) (statement of the U.S. Clay Producers Traffic Ass’n.); *Future of Rail Regulation: Hearing Before the Subcomm. on Railroads, Pipelines and Hazardous Materials of the H. Transp. & Infrastructure Comm.*, 104th Cong. 3 (1995) (statement of the National Industrial Transportation League).

exhaustive hearings, and amendments to related portions of the governing statute was evidence of Congressional ratification).

B. Responses to the Board's Questions about Specific Statutory Provisions Underlying the Competitive Access Rules

1. Reciprocal Switching

With respect to reciprocal switching, the Board asks for input on whether the “practicable and in the public interest” standard of 49 U.S.C. § 11102(c) “should be constrained by the provision permitting relief ‘where . . . necessary to provide competitive rail service.’” STB Notice at 6. When the ICC adopted the Competitive Access Rules, and limited the opportunity to claim relief to those situations where a rail carrier was engaged in a competitive abuse, it effectively determined that “constraining” the public interest standard in this manner was appropriate regulatory policy. *See, e.g., Intramodal Rail Competition*, 1 I.C.C. 2d at 829 (treating Competitive Access Rules as an implementation of ICC “public interest” jurisdiction); *Midtec*, 3 I.C.C. 2d at 178 (describing the task for evaluating competitive access under the rules as “the public interest analysis” for both reciprocal switching and terminal access). The D.C. Circuit twice agreed. *Baltimore Gas & Elec.*, 817 F.2d at 114-15; *Midtec*, 857 F.2d at 1500, 1511. Thus, the ICC and the courts have both answered this question affirmatively, and there is no reason for the Board to do otherwise.

Moreover, even under pre-Staggers authority, “public interest” as used in the statute means “more than a mere desire on the part of shippers or other interested parties for something that would be convenient” and requires “some actual necessity or some compelling reason.” *Jamestown, N.Y., Chamber of Commerce v. Jamestown, Westfield & N.W. R.R. Co.* 195 I.C.C. 289, 292 (1933) (refusing to order carrier to operate facilities as a joint terminal). The competitive abuse standard adopted by the ICC comports with this long-standing public interest

requirement. To depart from the rule would mean abolishing the competitive access requirements for reciprocal switching and would require development of a meaningful public interest standard that would apply only to reciprocal switching. Moreover, the Board would need to explain why the ICC, the *Midtec* Court, and Congress were all incorrect when they concluded that the same standard should be applied to both reciprocal switching and terminal access. *See, e.g., Midtec*, 3 I.C.C. 2d at 178 (“the underlying public interest test . . . is the same”). The Court affirmed the ICC’s conclusion, stating that “[t]he logical inference that the Commission’s discretion should be exercised and constrained in like manner under both provisions is strongly supported by the Conference Report on the Staggers Act,” *Midtec*, 857 F.2d 1487, which also equated the public interest standard under the two provisions.

2. Alternative Through Routes

The Board also requests input on the relationship between its authority to prescribe through routes under 49 U.S.C. § 10705(a)(1) and the limits on that authority imposed by 49 U.S.C. § 10705(a)(2). STB Notice at 6. Simply stated, § 10705(a)(1) establishes the general power of the Board to prescribe alternative through routes and § 10705(a)(2) imposes important restrictions on the manner in which the Board can exercise that general authority. That the Board’s prescription authority is limited by § 10705(a)(2) is explicit in its language, which provides that “[t]he Board may require a rail carrier to include in a through route substantially less than the entire length of its railroad . . . only when,” and then enumerates several exceptions. Specifically, the Board may order a shorter route if “required under section 10741, 10742, or 11102,” 49 U.S.C. § 10705(a)(2)(A), if protecting the carrier’s long-haul “would make the through route unreasonably long when compared with a practicable alternative through route,” 49 U.S.C. § 10705(a)(2)(B) or if “the proposed through route is needed to provide adequate, and more efficient or economic, transportation.” 49 U.S.C. § 10705(a)(2)(C). These are express

limitations on the Board's authority. By the plain language of the statute, the Board may not order a through route that short-hauls a carrier unless one of the conditions is satisfied.

The Board also asks "whether § 10705(a)(2) should apply where multiple carriers can originate the traffic, but only a single carrier can deliver the traffic to its destination." STB Notice at 6. There is nothing in the statute that would allow the Board to treat the requirements of § 10705(a)(2) as optional. The plain language of the statute indicates that the findings required under § 10705(a)(2) are mandatory if the Board wishes to prescribe a through route that short-hauls a participating carrier. Indeed, a prescribed through route that would short-haul *any* involved carrier is only permitted if inclusion of a given carrier's long-haul would "make the through route unreasonably long," § 10705(a)(2)(B), or if "adequate" transportation requires the proposed through route *and* the proposed route would be "more efficient or economic." § 10705(a)(2)(C). Presumably the Board's question is prompted by the statutory direction that the Board "shall give reasonable preference, subject to this subsection, to the rail carrier originating the traffic when prescribing through routes." 49 U.S.C. § 10705(a)(2). Giving "reasonable preference" to originating carriers cannot be construed as a license to avoid making the required findings with respect to a destination carrier. This is particularly evident as giving reasonable preference is expressly made "subject to this subsection," which can only mean subject to the required findings.

In its recent decision in *Entergy Arkansas, Inc. v. Union Pac. R.R. Co.*, STB Docket No. 42104, slip op. (served Mar. 15, 2011) ("*Entergy*"), the Board alluded to an additional issue concerning the prescription of through routes that was not raised in its notice for this proceeding. Relying on dicta in *Bottleneck I*, the Board stated that a "more relaxed standard" was established when *Bottleneck I* "suggested that a party could, under certain circumstances, obtain relief after

establishing that the prescribed through route was ‘better’ or ‘more efficient’ in lieu of making an anticompetitive conduct showing.” *Id.* at 7-8. The Board stated its intention to “reconcile” in this proceeding the new, “more relaxed standard” with the Competitive Access Rules. *Id.* at 8 n.16.

The Board did not elaborate on the potential contours of this alternative standard in *Entergy* because it determined that the proposed route was neither better nor more efficient. Nonetheless, AAR offers the following preliminary observations concerning the possible scope of such an alternative standard. First, the Board did not intend to create a more relaxed alternative to the Competitive Access Rules that requires only a showing that an alternative route is “more efficient” or “better” when it speculated in *Bottleneck I* on possible fact situations that could arise in future cases. The *Bottleneck I* passage referred to in *Entergy* speaks of applying the Competitive Access Rules, not of creating an exception to them. The Board stated clearly that it could not “declare in advance just what must be shown to make a competitive access case justifying the prescription of a new through route.” *Bottleneck I*, 1 S.T.B. at 1069. The Board concluded that “there is nothing in our competitive access regulations to preclude a competitive access remedy” if the shipper presented “sufficient facts” concerning the nature of the foreclosure. *Id.* The *Bottleneck I* Board thus envisioned an analysis of the facts surrounding a foreclosure of alternative routes by the bottleneck carrier within the context of the Competitive Access Rules, not the application of a separate, “more relaxed standard.” Moreover, the *Bottleneck I* decision had already clearly stated, in setting out the generally applicable rules, that a mere refusal “to open an additional through route at the shipper’s desired interchange point is not, by itself, evidence of anticompetitive conduct sufficient . . . to warrant the prescription of the route.” *Id.* at 1066-67. By distinguishing between mere refusal and “foreclosure,” *Bottleneck I*

indicated that the foreclosure would need to rise to the level of a competitive abuse before a prescription would be warranted.

Second, both the reviewing courts and the Board itself have consistently understood that the standard applicable to prescription of through routes is that established by the Competitive Access Rules, which require competitive abuse. *See, e.g., Baltimore Gas & Elec.*, 817 F.2d at 114 (affirming “Commission’s decision to prescribe through routes and joint rates . . . *only* to remedy or prevent ‘anticompetitive’ acts”)(emphasis in original); *Review of Rail Access and Competition Issues*, 3 S.T.B. at 98 (“the current regulations require a demonstration that the incumbent rail carrier has engaged in anticompetitive conduct”). Indeed, the court of appeals decision that affirmed *Bottleneck I* and the Bottleneck Rules generally recognized only a single competitive access standard: “To invoke these rules, the utilities would be required to show that the carrier engaged in ‘anticompetitive’ conduct.” *MidAmerican*, 169 F.3d at 1108. It would be inconsistent with judicial precedent for the Board to make a retroactive determination in 2011 that it had created a “more relaxed standard” in 1996.

Third, applying a standard that requires only a showing that an alternative through route is “better” or “more efficient” would be tantamount to revoking the Competitive Access Rules with respect to through routes. Effectively, the Board would be prescribing a through route whenever the statutory limitation on its authority to short-haul a carrier could be satisfied, *i.e.*, whenever the Board decides that the route to be prescribed “is needed to provide adequate, and more efficient or economic, transportation.” 49 U.S.C. § 10705(a)(2)(C).²⁸ The “more relaxed

²⁸ To the extent “better” was construed to mean something other than “more efficient or economic,” 49 U.S.C. § 10705(a)(2)(C), or that the existing route was “unreasonably long when compared with” the proposed route, 49 U.S.C. § 10705(a)(2)(B), the Board would lack jurisdiction to prescribe a through route that short-hauled any of the carriers involved, as discussed above.

standard” would completely occupy the field because it would never be necessary to show competitive abuse.²⁹

3. Definition of Terminal Facility

The Board expresses interest in “how the definition of ‘terminal facility’ evolved over time.” STB Notice at 6. Although the ICC and the Board have faced varying fact patterns over time, the definition has, in fact, evolved relatively little and has been consistently applied since shortly after the ICC was given the statutory power to grant terminal access to competing railroads.

Since the early 1920s, determination of what constitutes a “terminal facility” to which competitive access may be granted has involved a factual analysis of the character and use of the facilities to which access is sought. While the statutory provision governing grants of competitive access has never itself defined the phrase, the ICC consistently held that terminals are areas used by railroads for the “transfer, collection or delivery of freight,” and that a “terminal facility” is “any property of a carrier which assists in the performance of the functions of a terminal.”³⁰ *CSX Corp. – Control – Chessie Sys., Inc., and Seaboard Coast Line Indus. Inc.*, 363 I.C.C. 521, 585 (1980) (citing *Hastings Commercial Club v. Chicago, Milwaukee & St. Paul Ry. Co.*, 69 I.C.C. 489, 494 (1922)). Important considerations have included use of the facility, *Chessie Sys., id.*, as well as “the nature of the facilities and the character of the area in which

²⁹ A complainant showing competitive abuse would be entitled to nothing more than a complainant that made the minimal “more efficient or economic” showing under the statute because even when competitive abuse is shown the availability of the route prescription remedy is limited by the provisions of 49 U.S.C. § 10705(a)(2).

³⁰ Former 49 U.S.C. § 10523, which was unrelated to the ICC’s authority to grant terminal access, defined “terminal areas” as “areas within which carriers ‘transfer, collect or deliver’ freight.” *CSX Corp. – Control – Chessie Sys., Inc., and Seaboard Coast Line Indus., Inc.*, 363 I.C.C. 521, 585 (1980). Section 10523 was deleted by ICCTA.

they are located.” *Rio Grande Indus., Inc. – Purchase and Related Trackage Rights – Soo Line R.R. Co. Line Between Kansas City, MO and Chicago, IL*, ICC Docket No. 31505, 1989 ICC LEXIS 351, *27 (Nov. 13, 1989). Summarizing in *Rio Grande*, the ICC stated:

“[c]ircumstances the Commission have held significant include whether operations take place within railroad yard limits and whether service is performed within a cohesive commercial area. . . . The presence of team tracks, freight houses or assembly facilities has also been given significant weight.” *Id.* at *26-7 (citations omitted). Moreover, a “‘terminal area’ (as opposed to main line track) must contain and cannot extend significantly beyond recognized terminal facilities, such as freight or classification yards or team tracks, and a cohesive commercial area immediately served by those facilities.” *Id.* at *27.

The Board has had relatively few occasions to address the definition of terminal facilities. When it has done so, it has followed the lead of the ICC. *See, e.g., Golden Cat Div. of Ralston Purina Co. v. St. Louis S. W. Ry. Co.*, STB Docket No. 41550 (served Apr. 25, 1996) (summarizing ICC precedent on definition of terminal facility).

C. The Board’s Bottleneck Rules Are Sound and Constitute Established Law

In addition to the ICC’s adoption of its Competitive Access Rules in 1985, a second major agency ruling in the area of access policy involving access to railroad facilities was the Board’s adoption of its Bottleneck Rules in a pair of decisions issued by the Board in 1996 and 1997.

1. The Bottleneck Decisions

The Board’s *Bottleneck* decisions arose out of consolidated cases brought by coal shippers. In each underlying case, the coal shippers asserted the right to compel a bottleneck carrier to establish junction point rates to a point of interchange with a second, non-bottleneck

carrier and sought also to establish the right to challenge the reasonableness of a separately established rate on the bottleneck segment instead of the through route.

The Board's Bottleneck Rules give bottleneck carriers broad but not unlimited freedom to determine how they will handle traffic and what rates they will participate in. A carrier is not required to publish a separate rate for a bottleneck segment of a through route if the carrier already provides single line service from origin to destination or participates in an interline through movement. *Bottleneck I*, 1 S.T.B. at 1066; *Bottleneck II*, 2 S.T.B. at 237. A carrier also is not required to provide an alternative routing at the shipper's request unless a protesting party can demonstrate the need for the prescription of an alternate through route under the Competitive Access Rules. *Bottleneck I*, 1 S.T.B. at 1065-66; *Bottleneck II*, 2 S.T.B. at 237-38. A bottleneck carrier that does not provide single line service can be required to publish a separate rate for its portion of an interline movement if there is a contract covering the non-bottleneck portion of the through movement. *Bottleneck II*, 2 S.T.B. 244-45. A shipper cannot separately challenge a rate or obtain a rate prescription for the bottleneck segment unless the shipper has negotiated a contract rate for the non-bottleneck segment, in which case the separate rate established by the bottleneck railroad is subject to a rate reasonableness challenge. *Bottleneck I*, 1 S.T.B. at 1073-74.

The Board's Bottleneck Rules are based on the interaction of multiple statutory provisions, including the common carrier obligation, 49 U.S.C. § 11101(a), the duties to interchange and provide facilities for interchange, 49 U.S.C. §§ 10703, 10742, the carrier's rate-setting prerogative, 49 U.S.C. § 10701(c), and the carrier's route-setting prerogative and long-standing right to protect its long-hauls. 49 U.S.C. § 10705(a)(1), (2). These statutory provisions have not changed since the Board issued the Bottleneck decisions and those decisions were

affirmed by *MidAmerican*. The Board concluded at that time that the Bottleneck Rules were compelled by the statute and that reasoning remains binding today as it was 15 years ago.

In the first *Bottleneck* decision, the Board explained that the “utilities’ argument that they have a right to a local rate rests on the mistaken belief that, under the common carrier obligation, a carrier must hold out to provide all possible rates and services that a shipper may request.”

Bottleneck I, 1 S.T.B. at 1064. In fact, the statute specifically grants carriers the right to “establish any rate” under 49 U.S.C. § 10701(c). And the statute also protects a carrier’s long-hauls. 49 U.S.C. § 10705(a)(2). “Congress chose not to provide for the open routing that shippers seek here. To the contrary . . . Congress retained and strengthened the specific statutory provisions allowing carriers to select their routes and to protect their long-hauls.” *Bottleneck I*, 1 S.T.B. at 1067. Allowing shippers to dictate routing decisions “would defeat the statutory provisions protecting each railroad’s right to determine, at the outset, which reasonable through routes it will use to respond to requests for service.” *Id.* at 1065. The Board characterized the utilities’ demands for bottleneck rates as a request for “full regulatory intervention” that would “deprive carriers of their statutorily-recognized long-haul and their traditional routing discretion.” *Id.* at 1067. Such regulatory intervention would thwart “an integral part of Congress’ goal of revitalizing the rail industry” by taking back the freedom carriers had been granted to “rationalize their route structures making maximum use of efficient routings and eliminating others.” *Id.* at 1065 (internal quotation marks omitted)(quoting *Interchange Provisions at Jacksonville, FL, SCL & SRS*, 365 I.C.C. 905, 916 (1982)).

In *Bottleneck II*, the Board denied the shippers’ request for reconsideration of its original decision in *Bottleneck I*, stating that “giving shippers the rate control that they sought would not withstand legal scrutiny, as it would defeat a railroad’s right to determine, at the outset, the rates

that it will use to respond to requests for through service.” *Bottleneck II*, 2 S.T.B. 237.

Moreover, “[i]n the face of the discretion afforded railroads initially to select their rates and routes and to protect their long-hauls, [the Board] determined that the law simply does not provide these utilities the right, upon request, to segmented origin-to-destination service in the manner sought in these cases.” *Id.* at 239. Although the statute directs the Board to permit and encourage competition, “the shippers’ approach would go further and artificially force competition by impermissibly depriving the bottleneck carriers of their initial rate and route discretion.” *Id.*

On review of *Bottleneck I* and *II*, the United States Court of Appeals for the Eighth Circuit confirmed in its *MidAmerican* decision that the Bottleneck Rules properly preserve the statutory balance between rail and shipper interests struck by Congress. The Court observed that Congress struck a balance that “guarantees that shippers will receive rail service at reasonable rates, and [] allows carriers to provide such service in a manner that achieves revenue adequacy.” *MidAmerican*, 169 F.3d at 1106. The Board protected this balance by preserving carriers’ broad discretion to set routes and rates, which themselves reflect “Congress’s goal of deregulating the railroad industry and allowing railroads to achieve revenue adequacy by competing on a free-market basis.” *Id.* 1104-05. The Court particularly noted the important relationship between bottlenecks, differential pricing, and the ability of carriers to earn adequate revenues. It acknowledged that “an important part of achieving revenue adequacy is differential pricing.” *Id.* at 1106. “[R]equiring carriers to provide separately challengeable rates on bottlenecks would prevent them from exploiting bottlenecks and charging rates up to SAC for complete origin-to-destination service,” thereby undermining their ability to engage in differential pricing. *Id.* at 1109. A reduced ability to engage in differential pricing would, in turn, “impede the industry’s

efforts to achieve revenue adequacy, which is necessary for long-term capital investment, and ultimately, for a safe and efficient rail system.” *Id.*

2. Responses to the Board’s Questions Regarding Bottleneck Rates

A portion of the Board’s analysis in *Bottleneck I* addresses the requirement that where there is a through rate, shippers are “required to challenge the entire rate over a through route, and have not been permitted to challenge a discrete segment.” *Bottleneck I*, 1 S.T.B. at 1072. This requirement is supported by the rationale, stated in *Great N. Ry. Co. v. Sullivan*, 294 U.S. 458, 463 (1935), that “[t]he shipper’s only interest is that the charge shall be reasonable as a whole.” The Board requests input on how this through rate rule “can reasonably be applied in today’s transportation world,” and more particularly how it would apply to a hypothetical international movement involving multiple modes of transportation both inside and outside the U.S. STB Notice at 7.

The key question appears to be whether there is something about “today’s transportation world” that would suggest that it has become appropriate to evaluate only a segment of a total rail rate. The answer is no. An international movement involving more than one rail carrier was at issue in *Great Northern*, so these characteristics are nothing new that would support reviewing rail rates on a segmented basis. Nor is the fact that the international portion of the movement is outside the Board’s jurisdiction. That too was the case in *Great Northern*.³¹

The more fundamental point is that if the Board were to countenance the review of rates on a segment basis, it would be acting inconsistently with the statutory provisions that give rail carriers the prerogative to establish routes and rates in the first instance – provisions that formed

³¹ When the extra-jurisdictional portion of the movement involves non-rail transportation, it is questionable that the Board has the necessary expertise or the statutory mandate to attempt to engage in the assessment of rate levels that are outside the zone of authority delegated to it by Congress.

the basis for its original *Bottleneck* decisions. Giving shippers the right to demand rates on segments of through routes and to challenge the reasonableness of those rates would be tantamount to granting shippers the right to dictate carriers' routing decisions and to override carriers' transportation and capacity planning. As explained above, the Board has already determined that the statute does not permit such a result.

The Board's hypothetical movement raises a number of curious issues, but none relates to whether a segment-by-segment analysis of through rail rates has somehow become appropriate when the law did not permit such analysis in the past. The dominant feature of the Board's hypothetical is that most aspects of the movement are outside the Board's jurisdiction. The hypothetical posits an intermodal rail movement, but the Board has exempted such movements from regulation. The Board has no jurisdiction to regulate the level of domestic trucking rates. Moreover, to the extent that a movement similar to that described in the Board's hypothetical involved a true "through rate,"³² it is likely that such a rate could only be established by contract, which again would be outside the Board's jurisdiction.

D. Access Pricing

In its Notice initiating this proceeding, the Board requested commenting parties to address the subject of access pricing:

If the Board were to modify its competitive access rules, it would also need to address the access price. The Board seeks comments on what tools it can and should consider using (within statutory and constitutional limits) in evaluating how the carriers can assess terminal access prices, reciprocal switch fees, or segment rates. . . .

STB Notice at 7.

³² The statute gives the Board limited jurisdiction to regulate *rail* rates. Unless a movement occurs under an existing common carrier rate, which could not include non-rail transportation, there is no "rate charged or collected by a rail carrier for transportation subject to the jurisdiction of the Board" to challenge for purposes of 49 U.S.C. § 10704.

In the Board's formulation, the issue of access pricing would arise "[i]f the Board were to modify its competitive access rules." As AAR firmly believes that there should be no modification of either the Competitive Access Rules or the Bottleneck Rules, AAR will not address the subject of access pricing in detail here. However, AAR has two observations on this subject that it offers for the Board's consideration.

First, in a competitive market where an incumbent railroad is willing to grant access voluntarily to a competitor, the transaction would occur if the inclusion of the second carrier in the route, or the substitution of the second carrier for the first, would result in an overall more efficient service offering with attendant cost savings that could be shared by the two carriers. Under these circumstances, the incumbent carrier would insist on receiving its contribution from the service in question, *i.e.*, provision of service over the full route on its system, plus some incremental revenue as its inducement for entering into the transaction. For its more efficient services, the second carrier would insist on recovering its costs and realizing a portion of the efficiency gains resulting from its provision of service. Recognizing that regulatory solutions, where necessary, should seek to replicate the outcomes of competitive markets (e.g. the Board's SAC test is modeled on the workings of contestable markets), the Efficient Component Pricing principles outlined above would provide the only economically rational model for access pricing. Willig V.S. at 8-9.

Second, there is no reason to believe that shippers would ever even acknowledge the appropriateness of the competitive market access pricing model specified above. Their objective in pursuing involuntary access is not enhanced efficiency, it is lower rates. Thus, for railroads the prospect of involuntary access must always entail the possibility, indeed the likelihood, of reduced revenues because the pressure applied by shippers in the course of contested regulatory

proceeding would be expected to yield discounts off the access price predicted by the competitive market model.

V. THE BOARD SHOULD AVOID A CHANGE IN REGULATORY POLICY THAT WOULD DISCOURAGE FUTURE INVESTMENT IN RAIL INFRASTRUCTURE AND THAT WOULD ADVERSELY AFFECT RAIL OPERATIONS AND SERVICE

The Board's January 2011 Notice invited "comments from all interested parties on the positive and negative impact any proposed change [in access policies] would have on the railroad industry, the shipper community, and the economy as a whole." STB Notice at 7. As framed, the impact issue appears to be separate from the question whether any change in access policy "to facilitate competition" would pass legal muster. The answer to that question, as explained in section IV, is "no."

As to impact, AAR believes that the real world consequences of involuntary access could be dramatic and would adversely affect all shippers and the Nation's economy as a whole. A regime that results in lower railroad revenues, fragmented rail operations, higher operating costs and disincentives to investment would be bad policy.

For purposes of this proceeding, the Board cannot know what impacts would come to pass in the future but the Board can assess what projected impacts seem most likely in light of accumulated knowledge of how various regulatory schemes have played out in the real world in the past. Importantly, in the railroad context, there is extensive and unambiguous knowledge of how regulatory schemes have played out in the U.S. freight rail sector in the modern (i.e. post-interstate highway) era. Our knowledge is that in the pre-Staggers era of stifling regulation from roughly the mid-1950's through 1980, railroads were unable to respond effectively to market forces and, as a consequence, unable to sustain themselves financially. In the post-Staggers era, when railroads were permitted to respond to market forces to largely the same extent as

participants in other competitive markets, the industry achieved great efficiencies and cost reductions which it passed on to its customers in the form of lower rates. *See Burkhardt V.S. at 5; Rennie V.S. at 5.* By discarding unproductive assets and pricing in response to shipper demand, railroads were gradually able to cover their costs and have now put themselves on a sound financial footing. The accumulated knowledge regarding these two regulatory regimes argues strongly against adopting any new restrictions on rail pricing and routing freedoms.

A. Involuntary Access Would Not Yield the Benefits of Market Based Competition

In assessing claims of impact resulting from any proposed changes in access policy, the Board should be highly skeptical of the underlying premise of advocates of change that competition resulting from involuntary access yields benefits comparable to those generated by competition occurring naturally in the marketplace. Economic theory and real world experience both indicate otherwise.

As Professor Willig explains, market based competition produces efficient outcomes through freely set prices that reflect competitive conditions of supply and demand, with prices going down where consumers' demands weaken and going up where consumers' demands strengthen, both relative to supply. In this way, prices serve the important function of signaling where resources are most needed and motivating the needed supplies. *Willig V.S. at 2-3.* The experience of freight railroads and their customers in the post-Staggers era demonstrates unequivocally that competitive surface transportation markets function efficiently and result in an allocation of resources that serves the public interest. And where competition is not sufficient to create market outcomes, as the statute contemplates may be the case in some instances, the ICC and Board have regulated rates based on competitive market principle of contestability underlying the SAC test.

To participate in competitive freight rail markets, railroads must willingly put their capital at risk by investing in the facilities needed to serve their customers. So, to serve a new or expanded shipper facility, a railroad might install a new switch, or construct a new passing siding, or upgrade its track structure, or purchase new railcars. The railroad does so with the hope and expectation that it will earn a return on the capital invested in the facilities that will justify replacement of those facilities in the future. Under the regulatory scheme currently in place, freight railroads make thousands of such investment decisions each year. In many cases, investments are considered but not made because they are not projected to yield sufficient returns. But whether or not an investment is made, it is the railroad that would be putting its capital at risk that makes the decision based on its assessment of market conditions.

Attempting to create additional competition by involuntary access is inherently problematic because it bypasses judgments made by market participants. By requiring access, the regulator undertakes a decision that a market participant determined did not make economic sense and did not undertake.³³ And in many instances the result of that decision is that the railroad would be required to put its assets to a use that was inconsistent with its view of what the market called for. As Professor Willig explains, such involuntary actions cannot be expected to yield efficient market outcomes. Under a regime of expanded involuntary access, neither the price of access nor the price of rail/shipper transactions could be relied upon to reflect true willingness to supply the service or the true level of demand for the service. Moreover, involuntary actions could be further expected to stifle free market outcomes by undermining the incumbent railroad's willingness to invest. What railroad would be willing to put its capital at

³³ If efficiencies could be realized through the creation of access for a second carrier, one would expect the two carriers to undertake the transaction voluntarily and share the benefits. *See Willig V.S.* at 17.

risk in the future by investing in assets that a regulator might decide to make available to a non-investing competitor?

Real world experience, including experience with the open routing regime of the pre-Staggers era, suggests that involuntary access does not yield competitive market results. Moreover, the mandatory access regimes in other countries have not yielded the benefits of true market competition. AAR witnesses Edward A. Burkhardt and William J. Rennie have both had extensive professional experience with the regulatory regimes established for railroads around the world in the past 30 years. Mr. Burkhardt explains that European regulators have tried to manufacture competition through mandatory access by separating ownership of the rail infrastructure from rail operations, but this model has failed:

European shippers often have a wide range of rail carriers to choose from, but from what I have personally seen, those carriers offer prices far higher than US railroads due to the high costs paid for network access. European “open access” has erected a mountain of costs and inefficiency, while touting “competition on the rails” policies. I’m afraid there is no free lunch in Europe, any more than there is elsewhere.

Burkhardt V.S. at 9. As Mr. Rennie explains, “[t]he irony is that the European system, which is designed to foster competitive railroad service at rates subsidized by taxpayers, actually costs shippers more than service in the United States . . . due to the inherent institutional complexity, inefficiency, and fragmentation of the European system of forced access.” Rennie V.S. at 22.

B. Involuntary Access Would Undermine Railroads’ Ability to Earn Sufficient Returns on Their Capital Investments in Rail Assets to Attract New Capital

The governing statute provides that rail revenues should be sufficient to “attract and retain capital in amounts adequate to provide a sound transportation system in the United States.” 49 U.S.C. § 10704(a)(2)(B). This provision clearly contemplates that if expanded rail capacity is needed to provide a sound transportation system, railroads must generate sufficient returns to

attract the capital needed to pay for that expanded rail infrastructure. Thus, if the Board believes that additional rail capacity will be needed in the coming years “to provide a sound transportation system,” it must pursue policies that will allow railroads to earn revenues sufficient to “attract and retain capital in amounts adequate” to provide that additional capacity.

There is widespread evidence that increasing demand for freight rail service will require additional investment in rail infrastructure. *See Rennicke V.S.* at 23 (projecting “as much as \$150 billion to \$200 billion of required capital investment over the next 25 to 30 years”). Capital to support this expansion of rail capacity will be made available only if railroads have strong cash flows and only if investors are confident that they will realize returns on their investment that are at least as attractive as returns in other sectors of the economy.

The goal of those who seek involuntary access is to drive down railroad rates – and as a result railroad revenues – through manufactured competition. For purposes of assessing the likely impact of a change in access policies, the Board must understand that revenue reduction is the inevitable outcome of involuntary access. The imposition of involuntary access would not be revenue neutral. The Christensen Study certainly did not anticipate revenue neutrality. It viewed access proposals as the equivalent of requests for “rate relief” and stated:

Our assessment that, overall, the railroad industry is pricing at levels generating earnings that maintain or slightly exceed those necessary to ensure financial viability implies that there is little room to provide significant “rate relief” to certain groups of shippers without requiring increases in rates for other shippers or threatening the railroads’ financial viability.

Christensen Study at ES-39.

The threat to the railroads’ financial viability resulting from reduced revenues caused by new involuntary access policies would manifest itself initially as an unwillingness to invest

capital in the business to replace existing assets and purchase new ones. Mr. Rennicke explains that U.S. railroads:

must meet their substantial capital investment requirements now and in future years largely by reinvesting cash flows. In recent years, US railroad cash flow has been nearly sufficient to meet capital investment requirements; however, the railroads have had to access capital markets to fund a cumulative \$16.4 billion in capital projects during 1997-2009 that could not be funded through cash flows. . . .

Rennicke V.S. at 10. Reduced revenues resulting from involuntary access would reduce the cash flows available for capital investment and would make investments in railroads riskier and less attractive options for investors, thereby driving up the cost of capital for railroads.

History suggests that an initial unwillingness to invest capital in railroads with depleted revenues could eventually turn into an inability to invest. The downward spiral of the pre-Staggers era that culminated in a significant number of railroad bankruptcies involved a causal chain of diminished investment leading to reduced service levels leading to traffic losses leading to further reduced revenues leading eventually to an inability to invest. The only alternative to the downward spiral would be a massive infusion of government funds into an industry that is currently self-sustaining. Mr. Rennicke sees the scenario of diminished railroad revenues through involuntary access as leading to two alternative outcomes:

[R]ailroads would face the prospect of having to meet incremental demand for capacity with less cash flow available for capital investments. It would quickly become clear to investors and lenders that the regulatory system would permanently prevent the industry from earning its cost of capital. The result, inevitably, would be either deterioration of the US freight railroad network, as occurred during the last period of over-regulation, or a requirement that the government provide billions of dollars in funding for infrastructure, as is the case for most railroads overseas.

Rennicke V.S. at 21.

Neither deterioration nor government subsidy is remotely acceptable from the perspective of railroads, shippers or the economy as a whole. There is no good reason to take even the first step down a path that could lead to such outcomes.

C. Intrusive Regulation Would Adversely Affect Rail Operations, Resulting in Inefficiencies, Higher Costs and Diminished Quality of Rail Service

Another detrimental impact of involuntary access would be the likely disruption of rail operations and the reversal of the trend of carrier initiated efficiencies that has characterized the post-Staggers era.

AAR's witness Edward Burkhardt has spent his professional life running railroads in the United States and overseas. Mr. Burkhardt explains why vertically integrated ownership of rail infrastructure and the rolling stock needed to conduct rail operations is essential to running a sound freight rail network. *See Burkhardt V.S. at 7-9.* His views regarding the adverse impacts of involuntary access are born out of a lifetime of rail operating experience:

When I hear of proposals to "force" railroads to make their facilities available to their competitors or to establish junction point rates at interchange points designated by customers, I feel a deep concern. I would say that railroads will enter into access arrangements where markets give them the incentive to do so. . . . The idea that these types of coordination can be forced by regulation without creating new, higher costs is simply not rational. This type of non-market based thinking would result in higher costs due to more interchange requirements, higher costs due to requirements for more freight cars to serve the same amount of business and higher operating costs to switch and handle more cars.

Burkhardt V.S. at 7.

Testimony submitted in this proceeding separately by operating officers employed by AAR member railroads identify in detail the adverse effects on rail operations and costs that could be expected from forced interchange and forced access. Norfolk Southern Railway Company's Chief Operating Officer Mark D. Manion and Union Pacific Railroad Company's

Executive Vice President – Operations Lance M. Fritz explain that the inefficiencies and increased costs resulting from forced access and forced interchange would reverse decades of progress in building safe, reliable and efficient rail networks.

In the post-Staggers era, railroads have streamlined and rationalized their networks into competitively efficient systems that provide high-quality service. As Messrs. Manion and Fritz explain, today's freight railroads have achieved significant operating efficiencies and cost savings by consolidating traffic flows, maximizing long-hauls and train lengths, and minimizing car handlings. The ability of railroads to determine the points at which interchanges occur and to direct traffic flows through a limited number of interchanges has allowed them to achieve economies of density, which are reflected in reduced costs per unit of traffic.

Changing the Board's Bottleneck Rules to allow shippers to dictate the points at which traffic would be interchanged would be a particularly pernicious development that could undermine many of the efficiencies and service improvements that have been achieved over the past 30 years. By dispersing traffic flows through a wide range of interchange points at the request of individual shippers, such junction point routing would reduce existing economies of density and increase rail operating costs. Converting single-line traffic to interline traffic through forced interchange proposals would introduce additional car handling and interchanges, resulting in delay that would compromise service quality. To operate cars to rarely used interchange points, railroads would need to increase the number of blocks of carload traffic that they would have to build. Densities would be reduced as result of routing traffic through an increased number of interchanges. Transit times would increase as a result of the need to interchange traffic currently handled in single line service. Equipment needs would increase.

The ability of shippers to dictate interchange points would make operational planning and resource allocation more difficult by taking key decisions out of the hands of railroads. Modern railroad network operations are highly interdependent, featuring an overlay of carload, intermodal and unit train networks operating simultaneously over a single system. If railroads were to lose control over how they route cars on their system, the adverse effects on service would be experienced by shippers across the network and not just those who had availed themselves of the right to demand routing that suited their individual preferences.

Shipper-directed interchange and involuntary access would also have an adverse effect on investments in the rail network for operational reasons, as well as for the financial reasons discussed above. First, investment would become less efficient as it became necessary for railroads to upgrade numerous little-used interchanges to accommodate shippers' routing preferences rather than targeting investments on interchanges where it makes operating sense to consolidate traffic flows. Second, railroads would be less likely to invest in new facilities if they were placed in the position of having to guess about future traffic flows due to shippers' newfound ability to dictate routing of traffic.

Real world rail operating experience on U.S. freight railroads in the late 1990s and early 2000s teach that it does not take a tsunami to significantly disrupt a rail network. Given the interrelatedness of network operations, service disruptions can cascade across large portions of a rail system in a short time and spill across to the systems of connecting carriers. The Board should be careful to avoid any actions that could lead to a recurrence of such disruptions.

CONCLUSION

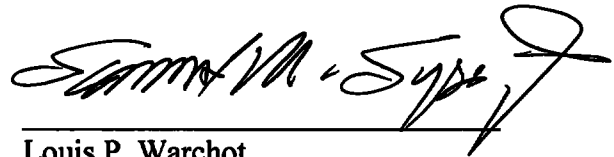
For the foregoing reasons, the Board should refrain from making any changes to its existing access policies. It should continue to implement the balanced regulatory scheme

established by the Staggers Act and work to advance the interests of railroads, shippers and the economy as a whole by pursuing policies that will foster increased investment in the Nation's rail infrastructure.

Respectfully submitted,

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April 12, 2011

**VERIFIED STATEMENT OF
EDWARD A. BURKHARDT**

VERIFIED STATEMENT OF EDWARD A. BURKHARDT

My name is Edward A. Burkhardt. My principal current affiliations in the United States are President and CEO of Rail World Inc., an international railway investment and management firm, and Chairman of the Board of Montreal, Maine & Atlantic Railway Ltd., a Maine-based regional railroad.

My career in the railroad business has spanned over 50 years. I started with the Wabash Railroad in St. Louis as Assistant to the Superintendent Transportation. After seven years with Wabash, and its successor, Norfolk & Western Railway, I joined the Chicago & North Western, serving in a multitude of posts including Vice President Marketing and finally Vice President Transportation.

In 1987 I led an investor group that created the highly successful regional railroad, Wisconsin Central, and was Chairman, President and CEO for 12 years. Subsequently I formed Rail World to acquire and manage rail properties worldwide, often working with investment funds on rail privatizations and reorganizations. I have been Chairman of Tranz Rail Ltd., the only railway of New Zealand, Australian Transport Network, with operations in the states of Victoria and Tasmania, Estonian Railways (the major railway in Estonia) and English, Welsh & Scottish Railway, the major freight hauler in the UK. Currently, I am chairman of the boards of Rail Polska (Poland) and Baltic Rail (Estonia). In addition, my US interests include serving as a director of Wheeling & Lake Erie Railroad, an Ohio-based regional carrier, and I am President of the San Luis Central Railroad, a short line serving southern Colorado.

Each of these rail properties has been unique, but all exhibit similar managerial imperatives, i.e. to maintain excellent customer service while rigorously controlling costs to remain competitive in the heavily contested transport markets found worldwide. This business

isn't rocket science, but it does take careful management of cost and service drivers to succeed, and close liaison with government to ensure the environmental, political and regulatory factors that lead to success are understood and promoted. Additionally, as an investor in railways, one must develop a good sense of what works and what doesn't work in terms of management and regulatory practices.

I appreciate the opportunity to offer comments to the Surface Transportation Board in this proceeding, which is designed to go to the heart of the shipper/railroad relationship in terms of service and competition. As the Board takes stock and considers what has happened in our industry in the more than thirty years since the Staggers Act (1980) redefined the regulatory scheme that had prevailed for the previous 90 years, I would like to provide the perspective of my own experiences.

When I joined the Wabash Railroad fresh out of college in 1960, I found a well maintained, well operated railroad, one of the more than 50 Class I carriers of the period. The Wabash spanned the Midwestern United States, from Kansas City to Buffalo, and also served St. Louis, Chicago, Detroit and Toledo. It was a subsidiary of the Pennsylvania Railroad, the "Standard Railroad of the World," and appeared to be a paragon of operational and financial strength.

But what I totally missed (and I wasn't alone) was that the Wabash and Pennsylvania, and all of the other railroads of that era, were already well down the slippery slope that soon led to bankruptcies, wholesale line abandonments, liquidations, and a merger movement often driven by desperation, particularly in the east and mid-west. The earliest portions of the interstate highway system were nearing completion by the mid 1960's, and the Federal and state governments had embarked on policies that had the effect of heavy subsidization of road

transport. The nation's economy had greatly changed in the years after World War II, while the railroads had a heavily regulated network that was largely created between the Civil War and the World War I period. Out of that heavy regulation came a very conservative, risk-averse management style. Additionally, the railroads were being bled white supporting an increasingly loss producing passenger network. Had I known then what I know now, I might have looked for another way to make a living!

I never would have dreamed within ten years one third of the rail network of the entire nation would be bankrupt. By the time that happened, I was on the Chicago & North Western, and what a management challenge that was! A professor at UCLA, George Hilton, had written a book about the Midwestern "granger roads,"¹ the rail network that was based on every farm being no more than half a day's trip with a horse and wagon to deliver grain to the local grain elevator and then make it home by sunset. By then we were in an era of good highways, and the overbuilt granger roads (of which CNW was one) were fading fast. Since the regulatory structure of that time did not permit easy rationalization of redundant lines, Professor Hilton predicted only one of the grangers would survive, and he believed it would be the Rock Island due to its "superior route structure." This didn't sit too well with us North Western people, and I don't suppose the Milwaukee Road people were taken with Hilton's thesis either. The actual result was the bankruptcy and liquidation of the Rock Island and Milwaukee, and the salvation of the North Western through its haulage agreements with Union Pacific for east-west intermodal

¹ The Transportation Act of 1958; A Decade of Experience, George W. Hilton, Indiana University Press, 1969.

and merchandise traffic, the development of the Powder River Basin coal fields in Wyoming and ultimate merger with UP.²

I could go on and on about life on the North Western. Not long after I started working there our network peaked at 12,000 miles, and served eleven states. Saying that we did not have the revenue to maintain a network of this size would be putting it mildly. When I was General Superintendent of Transportation, we encountered a particularly hot summer, and had numerous derailments due to heat buckles (also called “sun kinks”), where the track was insufficiently anchored (generally due to bad ties and ballast) to accommodate expansion of the rails in hot weather. After much management angst, we curtailed operations on some 5,000 miles of line between 10 am and 10 pm, which solved the problem of heat buckles but at huge expense in locomotive, car and train crew utilization, and customer service. Later, we took that same 5,000 miles of railroad out of service during spells of wet weather or for several weeks when the frost went out of the ground, since the “ballast” was essentially mud and the tie and rail conditions were simply awful. Today, in contrast, the current regulatory environment has allowed this light density network to be downsized to match the demands of today’s transportation markets with the remaining lines being upgraded with the track structure necessary to efficiently handle heavy unit trains of grain and ethanol in any kind of weather.

I don’t propose to have my testimony turn into a history lesson, but believe one needs to have a good understanding of the way things were in the pre-Staggers era to assess subsequent developments. Our industry today is virtually unrecognizable from what we had in the 1960’s and 1970’s. In fact, the situation prevailing then was totally unsustainable, and it was only a

² But only after UP spent eleven years before the Interstate Commerce Commission trying to merge with the Rock Island. The “Rock” went bankrupt while waiting for regulatory approval for the merger. The bankruptcy caused Union Pacific to decline consummation of the transaction.

matter of time until even the strongest railroad would be forced to cut back to only the most heavily used of its main lines, and even there viability was questionable.

Staggers gave us a number of major benefits, including:

1. The opportunity to price our business competitively, to meet the market, and the chance to eventually earn our cost of capital.
2. The opportunity to abandon lines where there was no prospect of sufficient traffic or revenue to cover the cost of operation.
3. The opportunity to sell off marginal lines to short line and regional railroads which had lower cost structures. This right gave rise to an entirely new industry with wide benefits to the rail market nationwide, particularly in rural areas.
4. Expedited merger procedures that allowed the railroad industry to create strong networks which would have the “critical mass” so necessary to achieve lowest possible unit cost and fully serve as many markets as possible.
5. Perhaps most important for purposes of this proceeding before the Board, the opportunity for railroads to rationalize their networks to focus on efficient routings and interchanges.

In the ensuing thirty years, the Class I’s have merged into seven major systems (including the two Canadian-based railways, both of which have extensive US operations), and have helped to create most of the current 600 regional and short-line railroads. Productivity has skyrocketed, and because 85% of these productivity improvements have been passed on to rail customers³, prices (on an inflation-adjusted basis) have declined sharply. Most importantly, after decades of decline, rail traffic has seen strong increases and overall market share has increased.

Accommodating the increase in volume on a physical plant that shrank significantly during the “bad old days” has required massive investment, virtually all of which has come from the railways themselves. This industry is unique, requiring capital investment of 17 cents of each revenue dollar just to replace assets as they wear out. This says you better have an operating

³ The Distribution of Post-Staggers Act Railroad Productivity Gains, B. Kelly Eakin and Philip E. Schoech, Christensen Associates, December 2010.

ratio of 83 or less just to have the cash flow to stay even in plant and equipment replacement.

This is the basic cost of staying in the railroad business over the long term. It doesn't even begin to include the money necessary to do things like pay taxes or to earn a return on capital for your owners.

Wisconsin Central has been the highlight of my time in the rail industry. WC was a true child of deregulation. We had nothing to hold us back, no excuses, no one to blame if we made mistakes. We started with a blank sheet of paper. If we made mistakes, they were our own. It was 3,000 miles of light density railroad, exactly the kind of railroad that drove the granger roads into bankruptcy. We had three fundamental management imperatives. First, we had an unrelenting focus on controlling and reducing costs so that we could serve the maximum possible number of markets. Second, we wanted all of our people to make customer service their top priority so that customers would want us to serve their markets. And third, we were focused on our employees, believing that highly motivated work force was essential in any business with high service standards. Our track maintenance and car and locomotive shop employees set new standards in productivity, quality and cost control, and our train crews did a lot of marketing by fostering close relationships with on-line industries. We doubled business in ten years, and repeatedly won shipper polls of "best railroads" even though virtually all of our customers were served by only one railroad -- WC. We were solidly profitable, whereas our predecessor broke even at best, and had no return on the extensive capital invested. We had a successful IPO, and our investors made a good return while our customers were able to increase their business by expanding their markets.

Today, many of the Class I's have achieved similar economics, and, in contrast to WC, they have economies of density that have allowed them to achieve even lower unit costs. All of this

has taken place in the free market with reasonable regulation and the Board's current competitive access rules. I shudder at the thought of these freedoms being restricted so as to produce results outside the scope of market-determined outcomes. When I hear of proposals to "force" railroads to make their facilities available to their competitors or to establish junction point rates at interchange points designated by customers, I feel a deep concern. I would say that railroads will enter into access arrangements where markets give them the incentive to do so. They have entered voluntarily into such arrangements in the past and will continue to do so in the future. Whether it involves interline rates, reciprocal switching, coordinated dispatching, development of efficient high-volume interchanges or joint use of facilities, the railroads have already undertaken these initiatives where the markets have required. The idea that these types of coordination can be forced by regulation without creating new, higher costs is simply not rational. This type of non-market based thinking would result in higher costs due to more interchange requirements, higher costs due to requirements for more freight cars to serve the same amount of business and higher operating costs to switch and handle more cars. Even more damaging would be the impact on the railroads' ability to invest in plant and equipment to serve their customers if they have no way of knowing if they will, or will not, be able to participate in their customers' markets and recover their investment costs.

The prospect of forced access is contrary to all that the railroads have been able to achieve during the last thirty years. In fact, it would ultimately lead to a return to the 1960's and 1970's when the rail network was slowly consuming itself and was on the road to destruction.

I would like to address briefly the overseas rail operations I have seen. The most common organizational structure in Europe (and in many other parts of the world) is for government to own a separately managed infrastructure company, and for freight and passenger train operating

companies to be able to use the infrastructure and compete with each other, much as trucks do when using the public road network. At first, this sounds very interesting, especially having government assume the infrastructure investment needs rather than having the railways provide the financing themselves. But it has turned out to be a bargain with the devil, and frankly doesn't work. I never was so pleased with the functionality of the North American railway network than after spending time as a rail manager in Europe!

The freight rail market share on European railways has dropped, in spite of strong political support for diversion from road to rail. The reasons are obvious – inefficiency largely driven by the industry structure, high costs and poor service – but the institutional and political obstacles to recognizing and dealing with these issues are formidable. Ultimately, Europe has taught us that a policy favoring rail growth is nice to have but it can never be a substitute for having a regulatory environment that recognizes the fundamental economics of rail networks.

Freight operators in Europe have no control whatsoever over the infrastructure and have to accept whatever the government-controlled infrastructure owner offers. A typical coal train in Poland or the UK handles 2,500 tons, while the current standard for western coal in the US is about 15,500 tons. The issue is axle weight and train length, both of which are rigidly held down by the infrastructure companies. Yet use of the European infrastructure is frightfully expensive. When I was CEO of English, Welsh & Scottish Railway in Britain, we calculated the infrastructure access fees per net ton mile were three times the all-in cost of owning and maintaining rail infrastructure in the US. This was due to both gross inefficiency, and a need to allocate network costs in a way that insured they were fully covered regardless of whether a freight operator used a particular portion of the network. Freight operators in Europe have only cars and locomotives to compete with. Competition between rail operators can be vigorous, but

the costs of the train operators are extreme due to the separation of infrastructure management from train operations and lack of incentives to achieve best scale economics, resulting in freight charges that must reflect costs far higher than those in North America. In Europe, the state-owned infrastructure owners have no incentive to improve their performance or make investments in their infrastructure since they do not have to respond to market forces. The need to get consensus from all users on infrastructure change makes it difficult to adapt infrastructure to the needs of the freight market. Even just among the freight carriers the loser in any new market would be opposed to any infrastructure change needed to support a competitor's entry into that market since ultimately he could have to participate in paying for that change. European shippers often have a wide range of rail carriers to choose from, but from what I have personally seen, those carriers offer prices far higher than US railroads due to the high costs paid for network access. European "open access" has erected a mountain of costs and inefficiency, while touting "competition on the rails" policies. I'm afraid there is no free lunch in Europe, any more than there is elsewhere.

I appreciate that these opening comments do not address specific proposals, but I would suggest principles that should guide us when considering changes to the competitive environment, specifically:

1. Consider the long-standing doctor's maxim: "First, do no harm."
2. Don't do anything that damages the profitability of the handling carriers, lest the carrier's ability to invest and reinvest be weakened.
3. Don't do anything that introduces inefficiencies to rail operations or that detracts from the economies of density that are so vital to developing lowest cost.
4. Don't do anything to separate or weaken the vertically integrated management and ownership structure that has served us so well (and the absence of which serves the Europeans so badly).

5. Do everything possible to foster partnerships between railways and customers, where lines of communication are fully functional, and where transportation and production is viewed as a single integrated process.
6. Respect the investment of both customer and railway in the distribution network, and work diligently to achieve best possible productivity from the capital involved.
7. Consider demands of the national economy, as well as environmental and highway congestion issues. All of these favor the rail mode, and all of them argue for increased investment in rail capacity. Do all possible to improve the privately owned railways' access to capital.

From my perspective, the current STB competitive access regulatory approach is reasonable regulation that will continue to permit a favorable climate for innovation and investment in the railway industry. In turn, this allows the carriers to expand services and capacity, and to better serve their customers. I don't want to see a return to the conditions that prevailed in the pre-Staggers period, or the adoption of the European policy of fostering competition on the rails, which is a sham.

Today's regulatory environment has worked well for railroads and their customers. Let us not take steps to put our achievements at risk.

VERIFICATION

I, Edward A. Burkhardt, declare under penalty of perjury, that the foregoing statement is true and correct and that I am qualified and authorized to file this statement.

Executed: April 7, 2011

A handwritten signature in black ink, appearing to read "Edward Burkhardt", written over a horizontal line.

Edward A. Burkhardt

**VERIFIED STATEMENT OF
WILLIAM J. RENNICKE**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**STB EX PARTE NO. 705
COMPETITION IN THE RAILROAD INDUSTRY**

**VERIFIED STATEMENT
OF
WILLIAM J. RENNICKE
PARTNER
OLIVER WYMAN, INC.**

April 8, 2011

Statement of William J. Rennie, Partner, Oliver Wyman

I. Introduction and qualifications

I am William J. Rennie, a Partner with Oliver Wyman, Inc. I have more than 30 years of experience consulting, both in the United States and overseas. My clients have included transportation companies, transportation users, and suppliers of goods, services, and capital to the transportation industry. My work has covered a wide range of management, regulatory, economic, litigation, and asset management issues. I specialize in transportation strategic planning, marketing, economics, and operations, and have particular expertise in restructuring and transactions to improve financial and operating performance of transport operators around the world. I am also a licensed representative of Oliver Wyman Transaction Services, a division of MMC Securities Corp. which is a US registered broker/dealer and member FINRA/SIPC.

I have previously provided expert testimony on North American rail issues on several occasions before the Surface Transportation Board/Interstate Commerce Commission, the United States Congress, various Federal Courts, and the Canadian Parliament.

During the late 1970's, prior to joining a predecessor company of Oliver Wyman, I was an active participant in the public and legislative process that led to the passage of the Staggers Act. At the time, I was the Vice President and Assistant to the President of the bankrupt Boston & Maine Railroad, which as you may recall was the only one of the "Eastern Bankrupts" that was not consolidated into Conrail. I believe that at the time the Boston & Maine's input was frequently considered, since we were the only bankrupt railroad that was able to reorganize totally within the private sector and, with the exception of one infrastructure loan, essentially without the use of any public funds.

Oliver Wyman and its predecessor companies also have participated in the restructuring of the railroad industry in the United States and in many countries around the world. Because of our private sector experience in the restructuring of the US rail industry, we have been asked by governments, shippers, and carriers on six continents to take the lessons learned in the United States and apply them to improving local rail systems. Starting in the late 1980's, I participated in the privatization of the Argentine railroads – the first railway privatization since World War II. Due to our success there and elsewhere, Oliver Wyman has subsequently participated in major rail privatizations and restructurings worldwide. For example, we were asked to manage the initial restructuring process for state-owned railroads in Poland, Hungary, and the Czech Republic, only months after each saw a change in political control. I also managed the concessioning of the Mexican railway – turning it from a money-losing government enterprise into several successful private carriers – and in Canada we participated in the privatization of the Canadian National Railway.

My purpose in providing this statement today is to provide the Surface Transportation Board (STB) with Oliver Wyman's perspective concerning the current state of competition in the railroad industry and proposals to change the current regulatory structure. Oliver Wyman's

perspective is informed by our experience with the crisis in the US railroad industry prior to the Staggers Act, our experience working with participants in the North American railroad industry since that time, and our work for a wide variety of carriers, governments, and other financial and non-financial participants in the global railroad industry.

II. The freight railroad network in the United States is the best in the world and a critical national asset.

It is worth remembering that from the late 1960's through the mid-1970's, more than half of the railroad system in the United States was in financial distress; all of the major railroads in the Northeast and two large Midwestern railroad systems were in bankruptcy. There is a consensus among those with experience on the subject that the rail industry's financial condition at the time was due in large part to excessive regulation. Congress responded to this crisis by reforming regulation through the 1980 Staggers Act, which paved the way for a fundamental restructuring of the industry, involving the efforts of railroads, shippers, labor, and other stakeholders.

I believe that all of the participants in that endeavor should be proud of the results. The Staggers Act created a healthy and self-sustaining freight railroad network, and the US regulatory and carrier model is now considered a standard and benchmark for freight rail systems worldwide. The Staggers Act also played an important role in eliminating or mitigating the substantial risk and uncertainty penalties that the financial community placed on rail investments, saving both carriers and shippers hundreds of millions of dollars over the past 30 years.

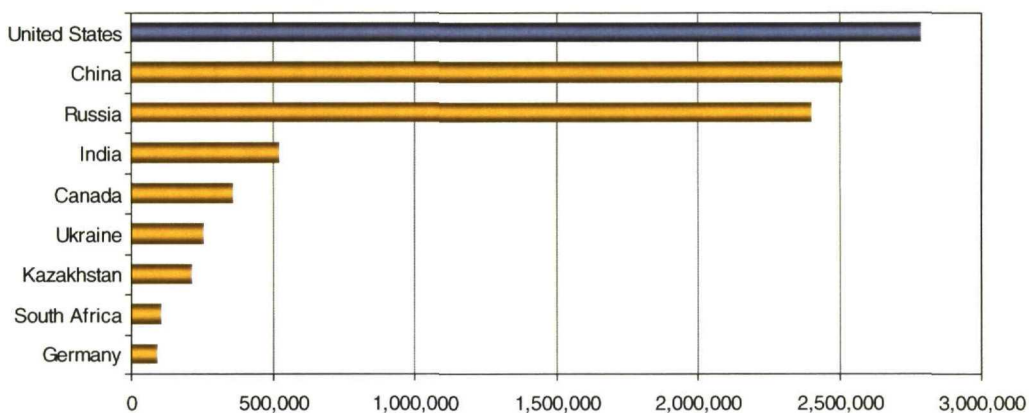
As Louis S. Thompson, for 13 years the World Bank's Railways Advisor, noted in a paper presented at the 2009 International Transport Forum, deregulation in the United States *"has been a demonstrably successful legislative initiative....Since the Staggers Act, railroad tariffs have fallen by over 50 percent in real terms. Although, as always, some commodities have benefited more than others, every major category has far lower tariffs and far better service than ever before....US and Canadian rail freight tariffs are the lowest in the world in PPP (purchasing power parity) terms. Over the same time, return on equity rose from an inadequate range of 1-6 percent to a still inadequate, but much healthier range of 8-12 percent."*¹

Today, the US rail network carries more metric ton-kilometers of freight, does so more efficiently, and charges its users less than any other major railroad system in the world (Exhibits II-1 to II-3).

¹ "Liberalization and Commercialization of the World's Railways: Progress and Key Regulatory Issues," Louis S. Thompson, International Transport Forum 2009. OECD.

Exhibit II-1: Major World Rail Systems in Freight Metric Ton-Kilometers

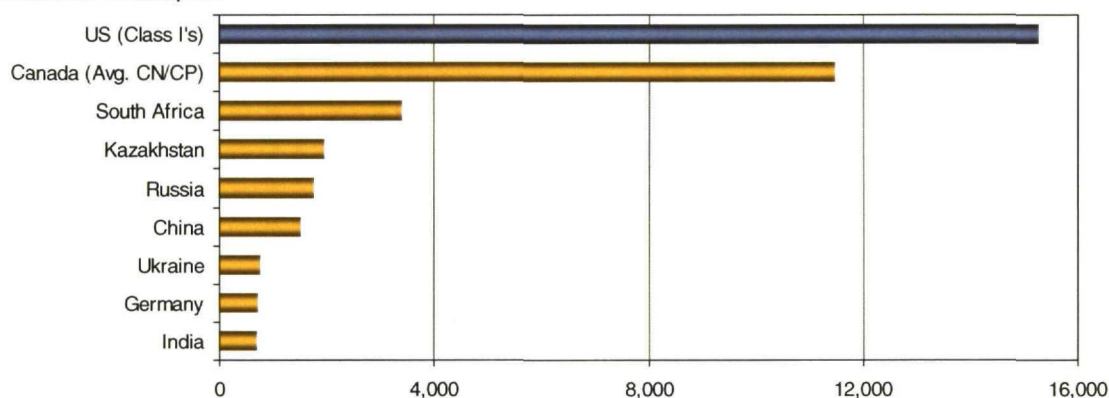
Millions



Source: World Bank, World Development Indicators, 2008 data.

Exhibit II-2: Employee Productivity of Major World Rail Systems

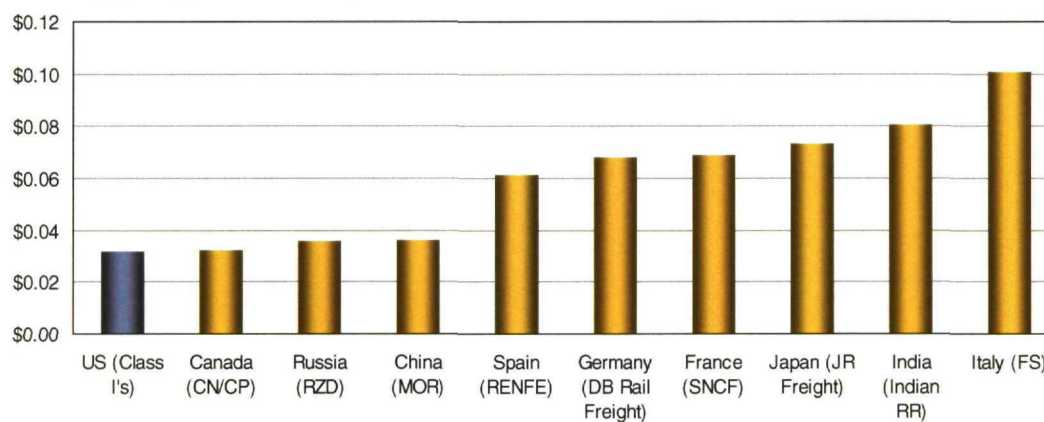
Thousands of tkm/pkm



Source: World Bank Railways Database, May 2007. Employee productivity = tkm+pkm per employee.

Exhibit II-3: International Rail Freight Charges: PPP Freight Revenue per Ton-Km

2006-2008 average, US\$, official exchange rates

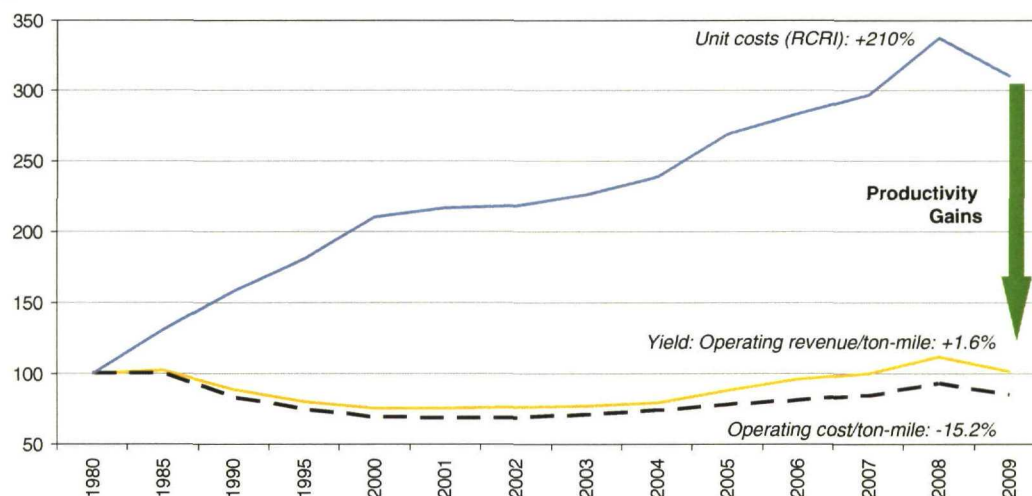


Data for named rail systems only, adjusted for purchasing power parity (PPP) and based on 2006-2008 averages. Source: Various international railroads and rail associations, World Bank.

The US railroads' best-in-class status is the result of enormous productivity increases that were made possible by the Staggers Act (Exhibit II-4). These productivity increases have largely been passed on to shippers, reducing shippers' logistics costs and making them more competitive internationally. As noted above, in inflation-adjusted terms, railroad rates in the United States have declined by more than 50 percent since passage of the Staggers Act. I would venture that few, if any, of the parties seeking changes in the railroad regulatory structure can make the same claim concerning the prices charged for their products.

Exhibit II-4: Indexed Average Revenues and Unit Costs, 1980-2009

1980=100

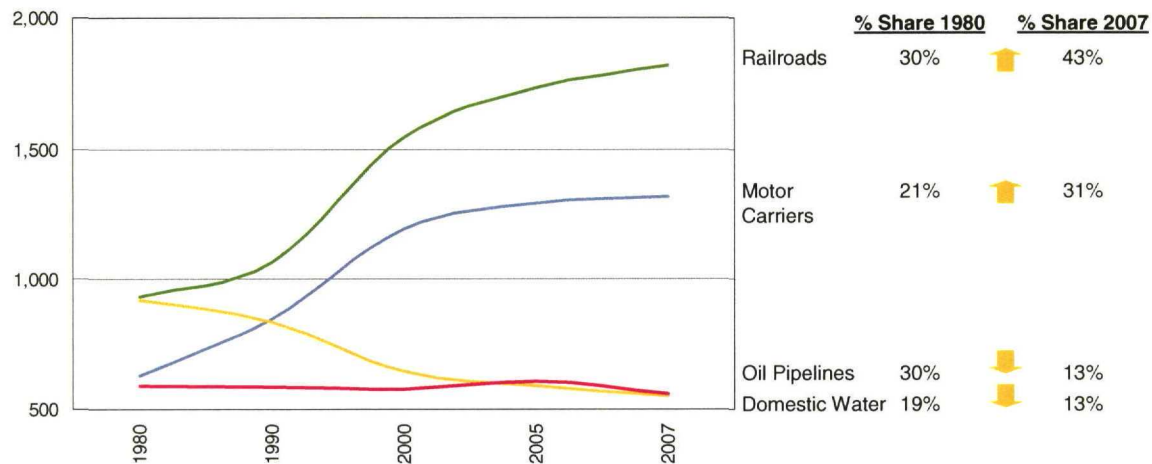


Note: RCRI= rail cost recovery index. Source: Analysis of Class I Railroads 2010 (March draft) and Railroad Facts 2010, Association of American Railroads; Oliver Wyman analysis.

The railroads also function as a critical national resource: Within the United States, railroads transport 43 percent of all freight (by ton-miles), the largest share of any transportation mode (Exhibit II-5). Railroads transport most of the nation's coal, grain, and chemicals. Moreover, the US freight railroad system has been able to forge a "win-win" partnership with the motor carrier industry to divert long-haul trailers and containers from the highway network to railroad intermodal service. This allows motor carriers to leverage the economics of long-haul railroad transportation (typically for movements of more than 750 miles), reducing their line-haul costs while providing shippers with convenient dock-to-dock service at lower prices than would otherwise be possible. During 2010, US railroads moved approximately 11.3 million trailers and containers for motor carriers and other customers, reducing both fuel consumption and congestion on the nation's highways and the highway infrastructure maintenance and construction costs that otherwise would have been paid by state and federal taxpayers. This is an increase of approximately 350 percent compared with 1980 (Exhibit II-6).

Exhibit II-5: US Revenue Freight-Ton Miles, Distribution by Mode, 1980-2007

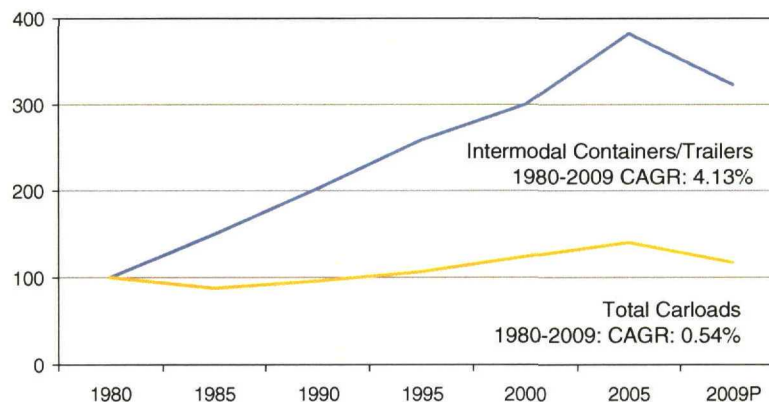
Billions



Source: Railroad Facts 2010, Association of American Railroads. Note that air accounts for 0.2 percent of RTMs in 1980 and 0.4 percent of RTMs in 2007. Primarily intercity ton-miles, includes non-Class I railroads. Numbers may not add due to rounding. Latest year data available.

Exhibit II-6: Indexed Class I Carload and Intermodal Volumes, 1980-2009

1980 = 1.00



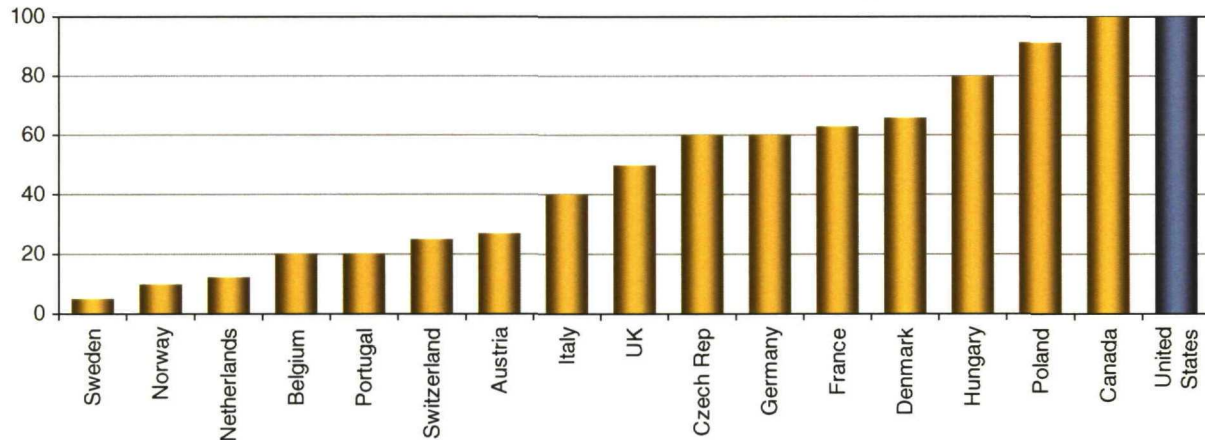
Source: Railroad Facts 2010, Association of American Railroads; Oliver Wyman analysis.

What is remarkable, to anyone with an international perspective, is that the US freight railroads have accomplished all of this while simultaneously operating without substantial taxpayer subsidies for operating costs or infrastructure costs – unlike most railroads in the world. Railroad infrastructure in Europe is generally owned and maintained by state-owned companies. Railroad operating companies that run over that infrastructure incur access (user) charges. As Exhibit II-7 shows, these access charges cover only a small percentage of variable (operating) infrastructure costs.

In the United States and Canada, however, both railroad infrastructure and operations are privately owned and operated by vertically integrated railroads. As the bar on the far right below shows, railroads in this country do not pay separate access charges; they do pay the full variable cost of the infrastructure they use and close to 100 percent of all fixed (capital) infrastructure costs incurred. In Europe, the freight railroads contribute almost nothing to fixed cost.

Additionally, far from consuming public dollars, US railroads are significant *taxpayers*: From 2000 through 2009, US Class I railroads paid more than \$57 billion in taxes (Exhibit II-8).

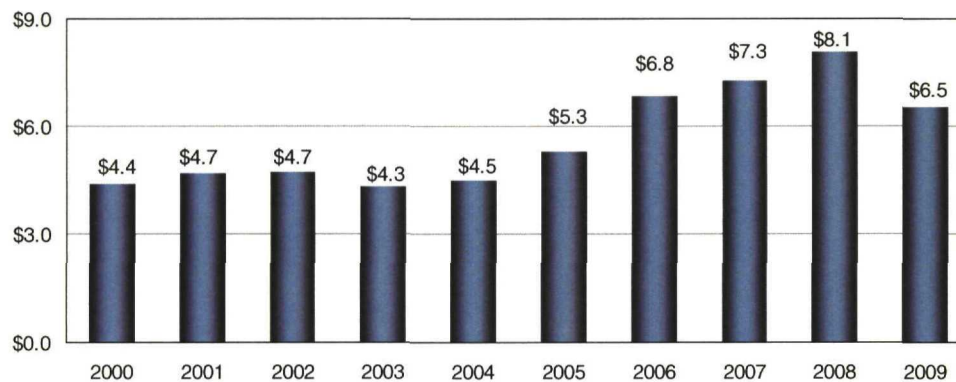
Exhibit II-7: Percent of Variable Cost Recovered from Access Charges



Source: Lou Thompson, Railways Advisor, The World Bank Transport Forum, Washington, DC March 10, 2005; Oliver Wyman analysis.

Exhibit II-8: Annual US Class I Railroads: All Taxes, 2000-2009

\$ billions



Source: Railroad Facts 2010, Association of American Railroads. Includes payroll, federal, state, local, and deferred taxes. Note: Federal fuel taxes paid since 1987, including an estimated \$3.2 million in 2009, are not included.

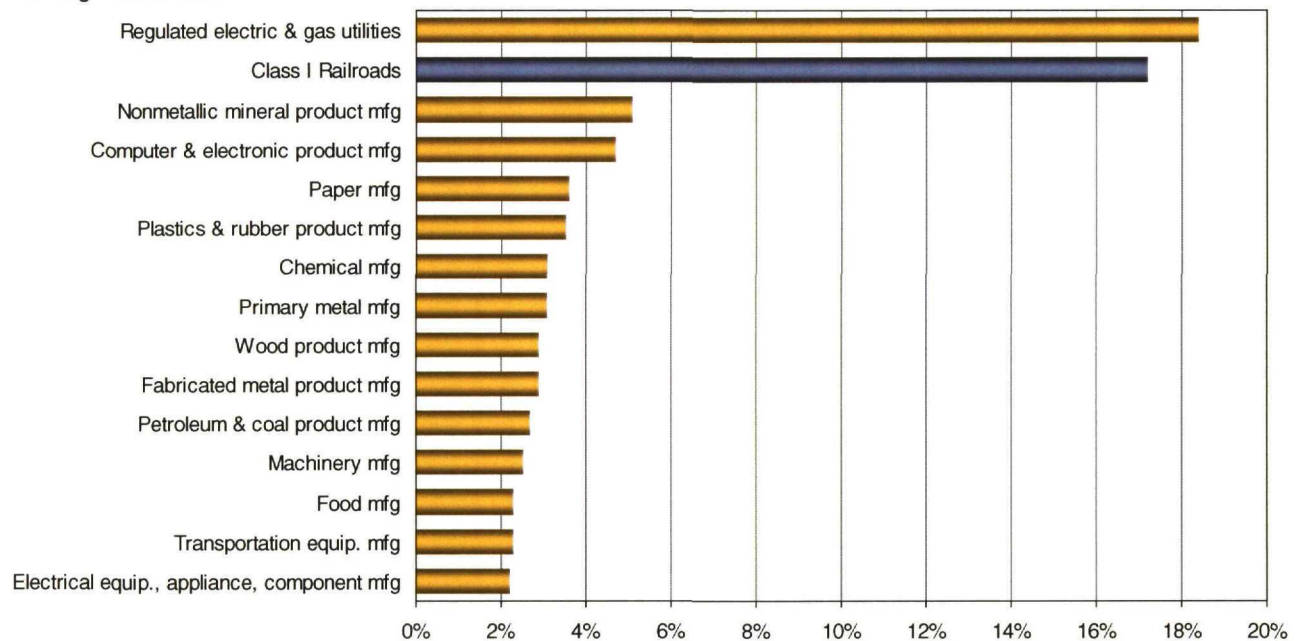
Based on 30 years of consulting for railroads and governments around the world, I can say unequivocally that the railroad system in the United States is both the envy of the world and a critical national resource. After undergoing a financial crisis caused largely by over-regulation – resulting in the bankruptcy of many major rail carriers – and subsequent restructuring, in the past three decades the US rail industry has grown into the most efficient rail system in the world. US railroads today carry a much higher percentage of the nation's traffic than do most railways elsewhere – and at a very low cost. And the industry is a net contributor, rather than a drain, on local, state, and national treasuries.

III. To remain an unsubsidized national asset, the freight network will require substantial private investment to increase capacity.

Railroads throughout the world, including those in the United States, are highly capital intensive. In fact, the railroad industry is the most capital intensive industry in the United States; its capital requirements as a percentage of revenue exceed those of the majority of its customers by a wide margin (Exhibit III-1).

Exhibit III-1: Capital Expenditures as Percent of Revenue for Various US Industries

Average 2005-2009

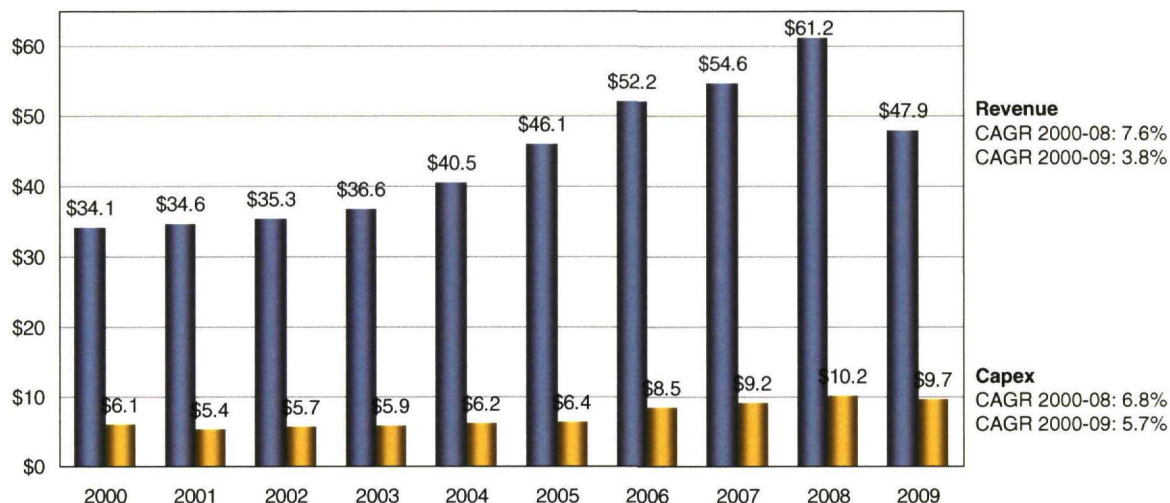


Source: US Census Bureau; Analysis of Class I Railroads, Association of American Railroads; Edison Electric Institute; Oliver Wyman analysis.

Between 2000 and 2009, the US railroad industry committed more than \$74 billion of private funds to capital investments, both to renew and upgrade the existing railroad network and to increase its capacity to meet the demands of and compete in the transportation market. Annual US railroad capital expenditures grew by a compound rate of 6.8 percent prior to the 2009 downturn (Exhibit III-2). This investment has permitted the railroads to keep pace with growing demand for railroad freight services: Revenue ton-miles carried by the railroads increased by 21 percent during 2000-2008 (prior to the 2009 downturn).

Exhibit III-2: US Class I Railroad Revenue and Capital Expenditures, 2000-2009

\$ billions



Source: Analysis of Class I Railroads, March 2010 draft and Railroad Facts 2010, Association of American Railroads; Oliver Wyman analysis.

To maintain its role as an unsubsidized national system, able to expand capacity to meet projected demand for freight transportation efficiently and at a low cost, the US rail industry will need to continue to invest enormous sums of private capital. The *National Rail Freight Infrastructure Capacity and Investment Study*, conducted by Cambridge Systematics in 2007, found that US railroads will need to invest \$148 billion in infrastructure to accommodate an increase in demand of 88 percent by 2035-2040 (depending on the duration of the current financial downturn). This estimate excluded maintenance, rolling stock, and land acquisition, and assumed no growth in passenger demand. Absent this investment, the study found that the portion of the US railroad network at or near capacity would increase from 13 percent today to 55 percent by 2035 (Exhibit III-3) and that “*The resulting level of congestion would affect nearly every region of the country and would likely shut down the national rail network.*”² Similarly, the *Report Card for America’s Infrastructure*, issued in 2009 by the American Society of Civil Engineers, estimated that US railroads will need to make capital investments of more than \$200 billion by 2035 to meet growing demand.

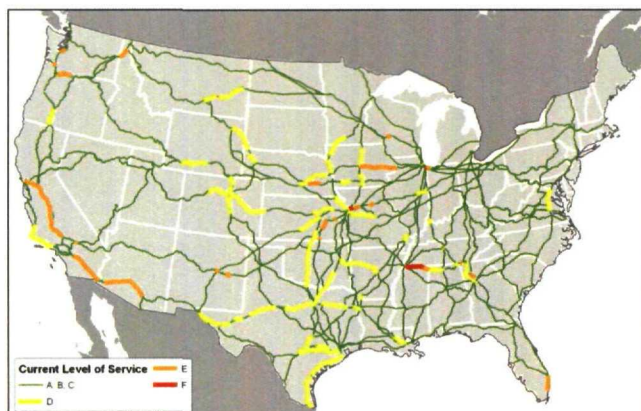
As a rail line nears capacity, it takes longer for a train to traverse the line, because more time-consuming “meets” occur in which one train must pass another, and there are fewer vacant “slots.” On top of this, unplanned events – such as weather, equipment failure, track failure, and grade crossing incidents – become much more disruptive. The bottom line is that without sufficient investment in infrastructure capacity, the railroads will become less reliable for shippers and costs will escalate. This phenomenon can be observed on international railroads that are unable to earn enough to cover their infrastructure costs and taxpayers – as often happens – are unable to make up the shortfall.

² “National Rail Freight Infrastructure and Capacity Study,” Cambridge Systematics, September 2007. pp. 5-6.

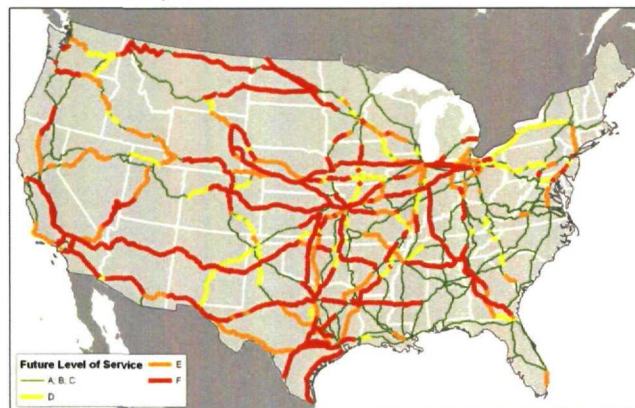
Exhibit III-3: 2035 Current and Forecast Traffic at Current Network Capacity

55% of the rail network will be near or over capacity by 2035

Current Train Volumes Compared to Current Train Capacity



Future Corridor Volumes Compared to Current Corridor Capacity
2035 without improvements



Note: Lines marked A, B, C (green) = below capacity; D (yellow) = near capacity; E (orange) = at capacity; F (red) = above capacity.

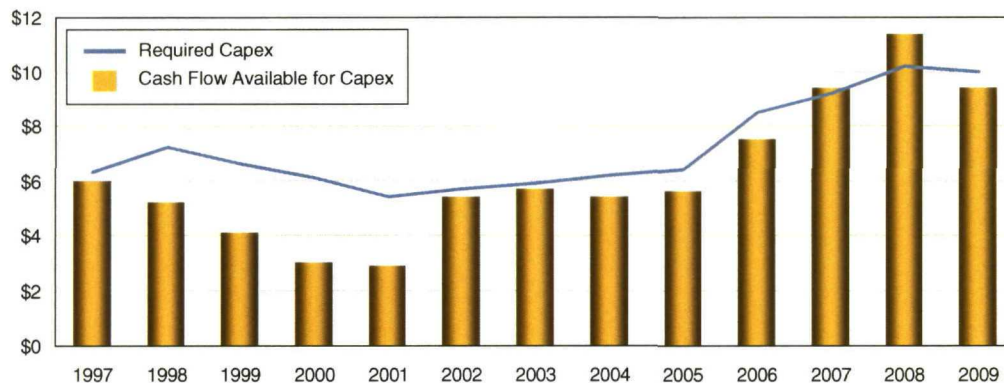
Source: "National Rail Freight Infrastructure Capacity and Investment Study," Cambridge Systematics, September 2007.

IV. To continue to invest in infrastructure to meet the expanding needs of shippers and support economic growth, US railroads will need to generate cash flow to fund capital investments and maintain access to the capital markets at sustainable rates to cover any shortfalls. Their ability to do so is uncertain.

Since US railroads do not receive government funds as do their counterparts overseas, they must meet their substantial capital investment requirements now and in future years largely by reinvesting cash flows. In recent years, US railroad cash flow has been nearly sufficient to meet capital investment requirements; however, the railroads have had to access capital markets to fund a cumulative \$16.4 billion in capital projects during 1997-2009 that could not be funded through cash flows (Exhibits IV-1 and IV-2).

Exhibit IV-1: Funding for Rail Capital Expenditures from Cash Flow vs. Required Capex, 1997-2009

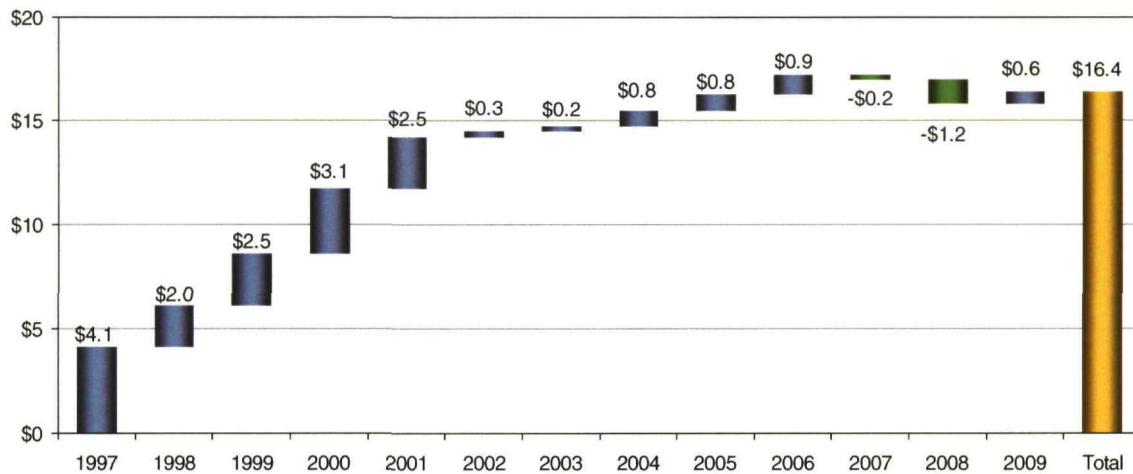
\$ billions



Note: Cash flow = net income + depreciation + deferred taxes +/- subsidiary adjustment - dividends - debt repayment. Capex = Equipment and roadway and structures only. Source: Railroad Ten Year Trends, Association of American Railroads; Oliver Wyman analysis.

Exhibit IV-2: Cumulative Operating Cash Flow Shortfall to Fund Class I Railroad Capital Expenditures, 1997-2009

\$ billions



Source: Railroad Ten-Year Trends and Analysis of Class I Railroads, Association of American Railroads; Oliver Wyman analysis.

In the late 1960's and 1970's, during the crisis brought on by over-regulation of railroad rates and services, many US railroads did not have sufficient cash flow to fund capital expenditures and many had very limited access to the capital markets. Railroads could access capital for rolling stock through equipment trust certificates, but little financing was available for infrastructure. The result was the deterioration of large parts of US freight railroad network infrastructure, leading to poor service levels and, in extreme circumstances, instances of trains falling off tracks while standing still.

As the Surface Transportation Board determined in November 2010, despite three decades of improved economic performance, no major US railroad earned the cost of capital for the railroad industry in 2009. The best performing railroad earned just 83 percent of the cost of capital, while the lowest performer earned less than 60 percent. Nonetheless, all major US railroads receive low to mid investment grades and, as noted earlier, are able to access the capital markets to fund infrastructure projects. The railroad industry's inadequate return on capital is offset, in part, by its relative historic lack of investment risk, which has been directly impacted by the stability of the regulatory process since the passage of the Staggers Act. For example, in upgrading the Union Pacific from BBB to BBB+ last October, Standard & Poor's Rating Services specifically cited "*the favorable risk characteristics of the US freight railroad industry.*"³ Uncertainty concerning the regulatory treatment of railroad rates, however, will undoubtedly increase risk in the railroad industry and make it a less desirable investment.

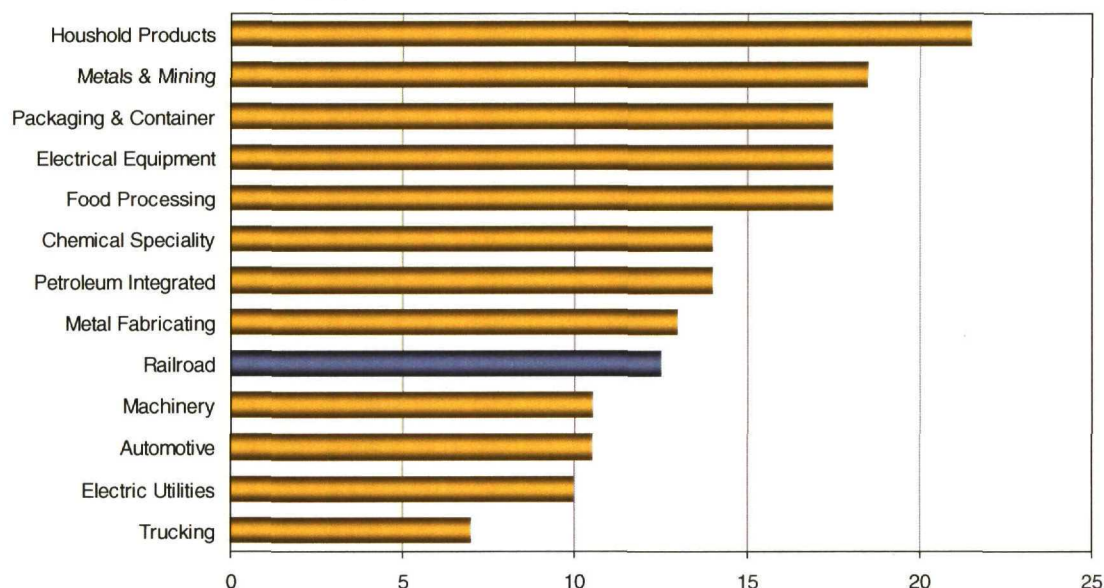
Investors in any company provide capital that they believe will be paid back with a return based on the cash flow that is generated by the assets. The ability of a company's assets to generate the required cash flow is based largely on the ability to leverage the time and place utility of those assets in the eyes of the customer. Like any private sector asset, *locations* on a rail network have differing competitive characteristics, each of which rolls up into the overall value of the network

³ "S&P hikes Union Pacific's credit rating to 'BBB+'," *MarketWatch*, November 18, 2010.

franchise. Private sector investors understand the value of a railroad's franchise and how those competitive locations interact to create the array of prices offered to customers. There is often a difference between the prices charged at points served by multiple rail carriers or that are open to product, source, or intermodal competition and other points on the network where there is less competition. The pricing patterns that the railroads have enjoyed over 30 years of stability provide the underpinnings to investors' assessments of the risks associated with the future stream of cash flows. As part of risk assessment, investors currently focus on issues such as the state of the economy, various forms of private sector competition (e.g., product, source, modal) and the performance of the rail network. The investor's assessment is typically performed with the understanding, however, that fundamental competitive characteristics will not be impaired or distorted by regulatory actions, which would in many cases create an unpredictable transfer of wealth from railroads to shippers.

Equity investors seek a return on their equity, and under the current regulatory structure, the railroad industry's return on equity is just average among US industry groups (Exhibit IV-3). Less than a decade ago, the railroad industry had the lowest return on equity of any industrial group; changes to the rate structure that would reduce railroad revenues without reducing their costs would cut railroad return on equity. Access to the equity markets for the railroads is influenced by a concentrated group of investors: the top 25 railroad investors collectively own nearly \$84 billion in railroad equities, or 48 percent of the market capitalization of the industry (as of December 31, 2010) (Exhibit IV-4). These institutional investors are highly sophisticated, and understand in detail the relationship between railroad earnings and regulatory constraints and the risks associated with the continued deployment of capital in the rail industry.

Exhibit IV-3: Return on Equity (%) for Various US Industries



Source: Value Line 2011 industry surveys; estimated data for 2010.

Exhibit IV-4: Top 25 Railroad Institutional Investors

\$ millions

Institutional Investor	BNSF	UP	CN	CSX	NS	CP	KCS	Total
Berkshire Hathaway	\$36,400							\$36,400
Capital Research Global Investors		\$4,395		\$2,997	\$1,326			\$8,718
Fidelity Management and Research		\$1,959	\$480	\$1,180	\$269			\$3,888
State Street Corporation		\$1,690		\$934	\$853		\$106	\$3,583
Vanguard Group, Inc.		\$1,667		\$877	\$838		\$184	\$3,566
BlackRock Institutional Trust		\$1,185	\$375	\$609	\$586	\$111	\$123	\$2,989
Capital World Investors		\$1,423		\$500	\$685	\$104		\$2,712
Cascade Investment Llc			\$2,625					\$2,625
Royal Bank of Canada			\$1,918			\$620		\$2,538
J.P. Morgan Investment Management		\$443		\$353	\$830			\$1,626
Marsico Capital Management		\$1,349		\$152				\$1,501
T. Rowe Price Associates		\$1,194		\$181				\$1,375
BMO Capital Markets			\$982			\$369		\$1,351
MFS Investment Management K.K.			\$1,124				\$58	\$1,182
Northern Trust Investments, N.A.		\$541		\$280	\$268			\$1,089
Norfolk Southern Thrift & Investment					\$1,019			\$1,019
Pyramis Global Advisors, LLC			\$430	\$181		\$361		\$972
Dimensional Fund Advisors, Inc.		\$421		\$251	\$237			\$909
Columbia Management Investment Adv		\$781					\$116	\$897
BlackRock Fund Advisors		\$362		\$203	\$198		\$128	\$891
Wentworth Hauser & Violich Inc.			\$395			\$435		\$830
Jarislowsky Fraser Ltd			\$812					\$812
TIAA-CREF Investment Management		\$371		\$206	\$181			\$758
BlackRock, Inc.			\$571			\$155		\$726
TD Asset Management Inc			\$446			\$243		\$689
Top 25 Institutional Investors	\$36,400	\$17,781	\$10,158	\$8,904	\$7,290	\$2,398	\$715	\$83,646

Source: ThomsonFinancial. Oliver Wyman analysis.

The value that equity investors place on the pricing practices of a regulatory regime is starkly illustrated by comparing the prices paid for the English, Welsh & Scottish Railway (EWS) and Grupo Transportación Ferroviaria Mexicana (TFM) when these two freight railroads were privatized.

- At the time of the transactions, the freight operations purchased by EWS had no control over infrastructure and were subject to competitive or open access at every point on the rail network. Not only would EWS face competition from other existing or start up railways, but a shipper could purchase a locomotive and cars and obtain a certified engine driver and go into the rail business itself. The pricing access regime in the UK provides the shipper with the negotiating leverage of both actual competitive offers and often “paper” offers, some developed internally primarily for negotiating purposes.

- TFM on the other hand had a competitive pricing system broadly similar to that of the United States, one that employed differential (or Ramsey) pricing principles. Since the government of Mexico wanted to completely end freight rail operating and capital subsidies, on TFM the wealth generated by the value of the rail franchise was left with the railroad, to attract the private capital needed to reverse over 100 years of inadequate public funding.

The result of these two transactions: in the UK, investors paid 38 cents for each dollar of gross revenue on the EWS, while they valued TFM at \$8.40 per dollar of gross revenue. It is telling that private investors were willing to pay 22 times more for TFM than for EWS, even though the obligation to fund infrastructure opex and capex was the buyer's responsibility in Mexico, and not in the UK. As the primary transaction advisor, Oliver Wyman's strong recommendation to the Mexican government to support differential pricing based on the competitive characteristics of traffic points obtained a much higher response from the private sector and a commitment to fund infrastructure without public support than did the sale of the open access freight operator in the UK. The difference shows the enormous importance investors and lenders place on the franchise value of a railroad, which is created through the railroad's exclusive control of the right of way and its ability to price its traffic under constrained market pricing principles.

Starting before the current economic downturn, some equity analysts were beginning to question the ability of the US railroads to support additional capital spending even under current regulatory exposure. Few equity analysts today discuss the state of the rail industry without comment on standalone (SAC) rate cases and other regulatory matters, and the negative implications for rail revenues. In addition, some major commercial banks in the United States, as well as European banks that supply capital to the US rail industry, are in the process of revising and tightening their credit and risk review processes. An important part of that tightening involves more rigorous risk assessment. All factors that could adversely affect revenue – including regulatory risk – are critical factors in risk assessment models. The hangover from the financial losses suffered by many investors and lenders in the airline industry, and tightening supervision of investments by regulators and internal risk management and credit processes required by the Basel accords, are increasing the scrutiny of railroad investments in equipment, track, and other infrastructure. Based on work I have done for confidential clients considering equity investments in the railroad industry, I can testify that such investors are unwilling to make significant investments in the face of regulatory constraints or regulatory uncertainty.

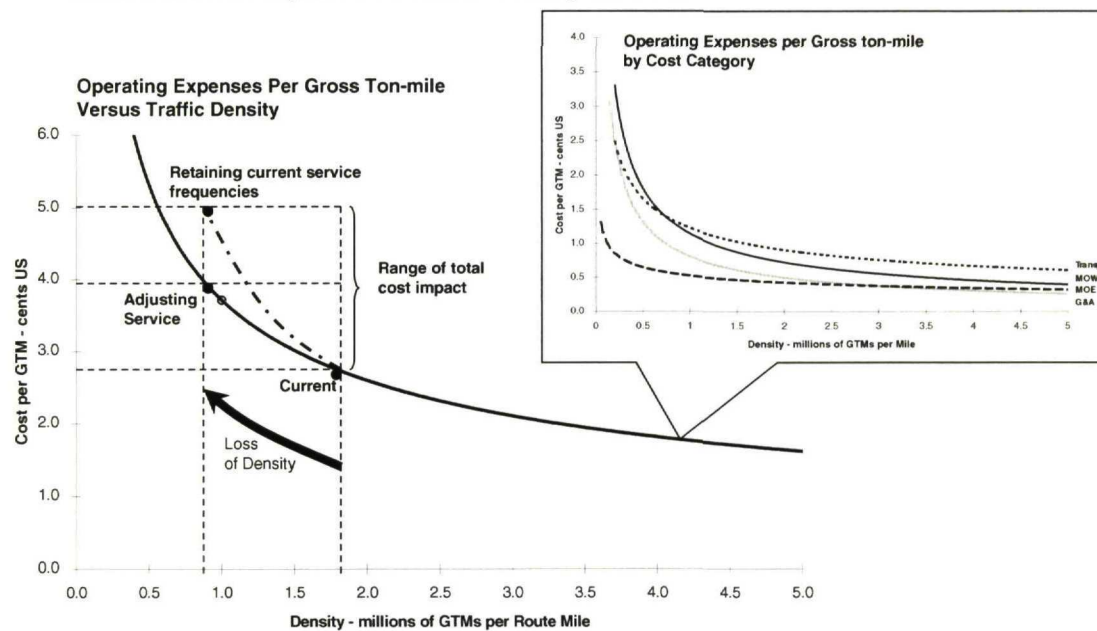
Access to the debt markets also depends on stable earnings. Oliver Wyman and its sister companies routinely evaluate and value asset investments on behalf of sponsors, investors, and lenders. During the past decade, we have assisted with more than 150 transportation-related transactions with a combined value in excess of \$40 billion. Uncertainty concerning the revenue stream that supports an investment, due to factors including unpredictable regulatory costs or regulatory action that could reduce revenues, is an important driver in the financial simulations that calculate the probability of default. Uncertainty regarding regulatory changes, as well as whether such changes are the beginning of an ongoing pattern, increases the probability of default, which in turn increases required loan reserves and the cost of funds and constrains their availability.

Regulatory actions that either directly or indirectly impede the railroads' ability to adequately price their services, that add substantially to their administrative costs, or that introduce uncertainty into income projections will complicate the railroads' ability to fund capital improvements demanded by the shipping community. In particular, actions that depart from the current status quo of Ramsey pricing that is applied based on the competitive characteristics of each traffic point or that subject large blocks of traffic to an expanded regulatory process will adversely affect investment decisions and likely increase the cost of the funds needed to make capacity improvements. This in turn will increase costs for all railroad users, and may make the difference as to whether needed capacity expansions can be funded at all.

V. Alternative through routes, terminal facility access, reciprocal switching, and mandatory bottleneck rate alternatives will both erode railroad operating income and increase the operating costs of the incumbent carriers. This will further reduce their ability to fund critically needed increases in infrastructure capacity.

Over the past 30 years, one of the key foundations of the US railroad industry's improvement in operating performance has been an increase in traffic density. Higher density has enabled railroads to reduce freight rates and earn returns needed to maintain access to capital, and provided incentive to invest. As Exhibit V-1 (left side) illustrates, the greater the density on a route or between traffic origin and destination, the lower operating expenses will be (as long as there is adequate capacity on the line). In addition, in many cases, higher density provides opportunities for improved service and reliability, as larger volumes of traffic require less intermediate handling (thus bypassing yards and terminals) and drive improvements to infrastructure that further increase track speeds and reliability.

Higher density reduces operating costs in all categories (Exhibit V-1, right side). On the other hand, splitting efficient levels of activity often leads to higher costs, which are commonly referred to as fragmentation penalties. Exhibit V-2 presents two illustrations of such fragmentation penalties developed from a European open access analysis. It is clear that as the size of crew and locomotive depots decline, the penalty for fragmentation increases. Exhibit V-3 illustrates findings from another European access analysis, which suggested that the magnitude of overhead costs increases as the fragmentation of operations increases.

Exhibit V-1: Illustrative: Impact of Traffic Density on Costs

Source: Oliver Wyman analysis of Class I and regional railroads.

Exhibit V-2: Illustrative: Operational Scale Fragmentation Penalties

Train crew		Locomotives	
Size of Depot (# of crew)	Penalty of Splitting	Size of Depot (# of locomotives)	Penalty of Splitting
100+	0%	100+	0%
80	3%	60	4%
40	7%	30	5%
20	18%	15	20%
10	30%		

Additional penalty of fixed depot costs (or partition): \$50K per new depot

Additional penalty of fixed depot costs (or partition): \$100K per new depot

Note: "Penalty of splitting" represents the percentage increase in operating cost that is likely based on splitting the depot. Source: Oliver Wyman analysis.

Exhibit V-3: Illustrative: Overhead Scale Fragmentation Penalties

Example of Overhead Scale Penalties
on Headquarters Functions: One
Business Split into Two Parts

Corporate HQ Function	Penalty of Splitting in Two
Finance	15%
Human Resources	25%
Info. Sys and Telecom	20%
Purchasing and Materials	25%
Property	10%
Admin, Legal, Internal Audit, Other	2%
Payroll On Cost and HQ Depreciation	17%
Overall	17%

Example Application: Penalty of Scale Loss with Increasing Fragmentation

Number of Equal Sized Companies ¹	Penalty of Scale Loss	Corp. Overhead Devolved to Each Co. (\$M)		Total Penalty (\$M)
		Base	After Penalty	
1	0%	128.8	128.8	0
2	17%	64.4	75.3	21.8
4	37%	32.2	44.1	47.6
8	60%	16.1	25.8	77.6

Note: 1. Size defined as total direct expenditure. Source: Oliver Wyman analysis.

While Oliver Wyman has not completed a fragmentation analysis focused on the points in the United States where forced access would reduce operating density, there is a high probability that splitting the traffic would increase operating costs and reduce volumes for the incumbent carrier. Each of the categories of proposed regulatory change has its own unique levels of impact:

- **Alternative through routes:** During the 1970's, the 3R and 4R processes addressed the proliferation of thousands of alternative through routes and the substantial negative impact on railroad economics and services. The structuring of Conrail collapsed dozens of routing options between origins and destinations into one or two high-density, high-service options. For example, FRA studies completed during the 1970s found more than a dozen routing options even on shorthaul traffic pairs such as Buffalo, NY to Boston, MA. Forced access arrangements that would promote the proliferation of alternative through routes could result in service and cost inefficiencies similar to those of the 1970's.
- **Terminal facilities:** Increasing access to terminal facilities would increase the amount of classification required at the terminal, increasing terminal expenses. By fragmenting traffic over multiple routes, it also would increase through train operating costs and degrade service levels. Additionally, as forced access options are imposed, and the number of blocks increase, the size of traffic blocks would decrease, often to a point where classification would become uneconomic. When block sizes fall and traffic for multiple points has to be combined to keep up volume, then cars must be reclassified at one or more additional yards and terminals along the route. At current terminal dwell times, each reclassification increases transit time by 26 hours for each movement.⁴

⁴ Notice, National Industrial Transportation League, April 4, 2011, p. 7. Average for BNSF, UP, CSX, and NS for week of March 25, 2011.

- **Reciprocal switching:** Increased access to reciprocal switching points would have an effect similar to increased terminal access. Current traffic block size would be reduced if forced competitive switching access is mandated. Additionally, the number of blocks and required switches would increase, as traffic for the incumbent carrier would have to be separated from traffic going to one or more access carriers. Multiply these blocks by expanded through routes, and the probability of fragmentation increases. The net result is that operating costs would increase (see Exhibit V-1) and transit times and service would worsen.
- **Mandatory bottleneck rates:** Requiring a bottleneck rate opens up the potential for an access carrier to replace the continuous through movement of the incumbent carrier. Establishing bottleneck interchange points where no traffic has been historically interchanged would require a whole range of operating changes, including crew on duty points and locomotive ready and service tracks, and would inject handlings (and the accompanying delays) where none previously existed. In addition, it could possibly increase infrastructure, freight car, and locomotive requirements.

VI. No matter how they are structured, proposals to modify the Board's existing rate regulatory policy are, at the end of the day, proposals to shift responsibility for funding needed capital investment in the US railroad network from the users to the government. If implemented, these proposals would create a new, de facto subsidy for a small class of rail users. This subsidy would cause either a new spending burden for the government or deterioration of the railroad system or, most likely, both.

As the members and professional staff of the Surface Transportation Board know, the Board has considered issues related to railroad pricing many times since passage of the Staggers Act more than 30 years ago. The Board has uniformly found that a pricing policy based on differential pricing principles is the most equitable way to allocate the cost among all users of operating, maintaining, and expanding the rail network, subject of course to the standalone cost constraint.

Under the current railroad pricing regime, the US railroad industry has not been able to price its traffic – including its potentially captive traffic – at a level sufficient to earn its cost of capital. As noted in the recent *An Update to the Study of Competition in the U.S. Freight Railroad Industry* by Christensen Associates, and prepared for the STB, “*Railroad industry marginal cost has been increasing at a faster average annual rate than railroad revenue per ton-mile. Consequently, the measure of railroad market power has been decreasing.*”⁵

As noted earlier, under the current pricing regime, US railroads have over the past 13 years fallen more than \$16 billion short of the cash flow to fund needed capital investments. This shortfall has been covered by the capital markets. Even before the current downturn, however, capital market analysts were questioning whether the railroad industry can sustain further capital investments, particularly if it cannot earn its cost of capital. Yet, over the next 25 to 30 years, the railroad industry will need to invest between \$150 billion and \$200 billion to create the capacity required to continue to provide efficient, low-cost service to the United States economy. Rather

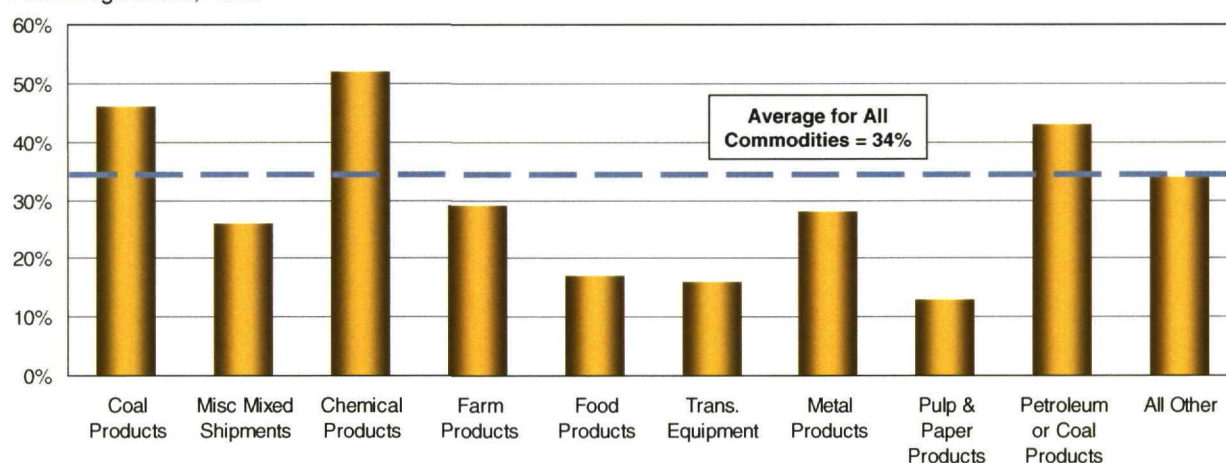
⁵ “An Update to the Study of Competition in the US Freight Railroad Industry,” Laurits R. Christensen Associates Inc., January 2010, p. i.

than allowing prices that are too high, it appears that the current regulatory system and market forces are combining to keep rail prices in the United States – which are already among the lowest in the world – too low to sustain the national freight rail network.

Proposals to change current STB policy on rail pricing all have the purpose of lowering railroad rates still further. Most proposals would accomplish this objective by weakening the railroads' ability to set prices for the 34 percent of rail shipments that are defined as "potentially captive" because they generate revenues above 180 percent of variable costs (Exhibit VI-1).

Exhibit VI-1: Share of Total Revenues Generated by Traffic with R/VC Ratio >180, By Major Commodity

Percentage share, 2008

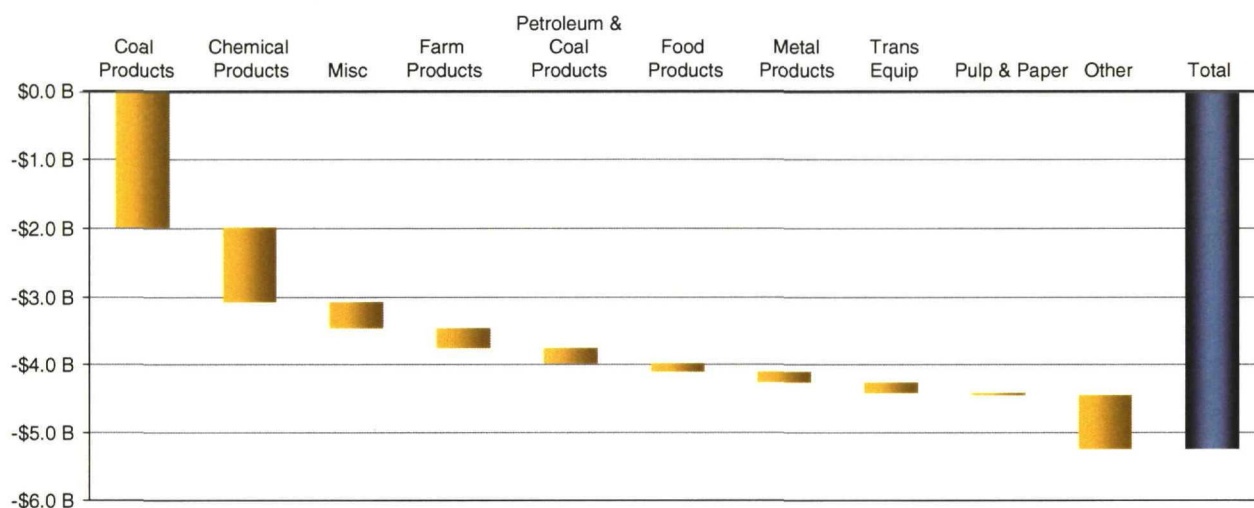


Source: Surface Transportation Board Commodity Revenue Stratification Report for 2008: Summary of Revenues and URCS Variable Costs by Two-Digit STCC and Revenue-to-Variable Cost (R/VC) Ratio Category, based on 2008 Waybill data; Oliver Wyman analysis.

To provide one estimate of the size of the problem this could create, if the rates for all traffic currently moving under rates subject to regulation (rates with an R/VC ratio of >180) were reduced by forced access to rates with an R/VC ratio equal to 180, the railroad industry would lose \$5.2 billion annually in revenue.⁶ Since traffic and variable costs would remain constant, reductions in revenue would fall straight to the bottom line, reducing contribution by approximately 30 percent (Exhibit VI-2).

⁶ The current proposed changes to pricing that would result from an increase in competitive access do not set R/VC = 180 as a target. This figure is used only as an illustration of the impacts. It is quite possible that the average R/VC would be reduced to less than 180.

Exhibit VI-2: Impact of Lowering Rates with R/VC Ratio >180 to Rates with an R/VC Ratio = 180
 Analysis of rates >180 R/VC, 2008



Source: Surface Transportation Board Commodity Revenue Stratification Report for 2008: Summary of Revenues and URCS Variable Costs by Two-Digit STCC and Revenue-to-Variable Cost (R/VC) Ratio Category, based on 2008 Waybill data; Oliver Wyman analysis.

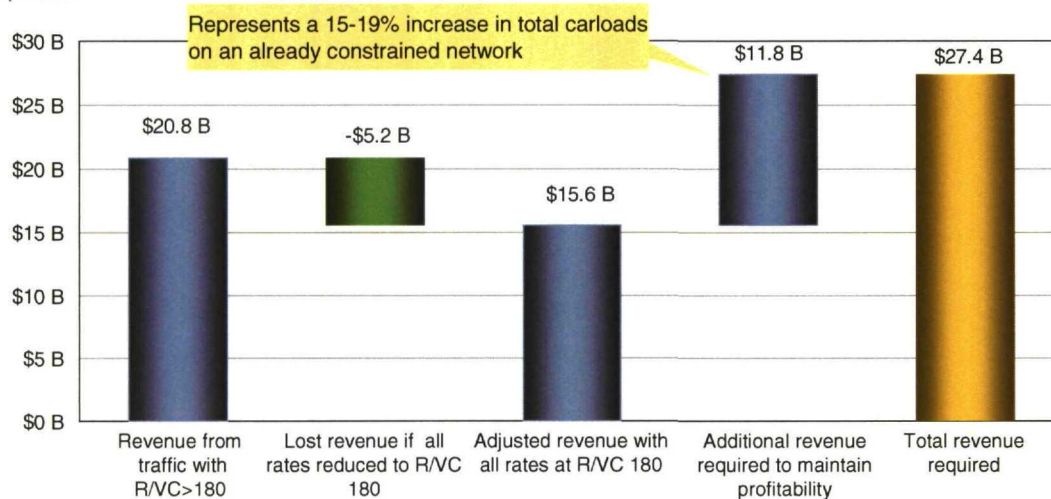
Exhibit VI-3 illustrates how the loss of \$5.2 billion annually in revenue and contribution would affect the railroad industry. The blue bar on the left shows the \$20.8 billion in revenue the railroads earned from rates that generated revenue that was above 180 percent of variable costs. The green bar shows the loss of \$5.2 billion in revenue if all of these rates were reduced to 180 percent of variable costs, which is presented in greater detail in Exhibit VI-2 above. The revenue remaining after deducting this \$5.2 billion would be \$15.6 billion. Since all of this traffic would continue to move, railroads' costs would at best be unchanged but likely would increase further because of additional handlings, and other inefficiencies that would be introduced⁷ – thus the entire loss of at least \$5.2 billion in revenue would fall to the bottom line.

If railroads are to continue to fund their operations and infrastructure without a subsidy from the taxpayers to cover this revenue loss, then the railroads would need to replace this \$5.2 billion in lost revenue. Since they would now be limited by access provisions to rates of no more than 180 percent of variable costs, however, the railroads would need to somehow immediately acquire \$11.8 billion in new traffic moving at an R/VC of 180 to cover the lost profits (contribution). This is not a likely development. Even if it were, this traffic would then be added to an already heavily utilized railroad network, at a minimum accelerating the need for capital investments.

⁷ See Section V on fragmentation penalties.

Exhibit VI-3: Incremental Revenues Required to Maintain Current Profitability, if R/VC Limited to 180 or Less

\$ billions, 2008



Source: Oliver Wyman analysis of Class I railroads.

More likely, the replacement traffic would not be immediately available, particularly at an R/VC of 180, and the railroads would face the prospect of having to meet incremental demand for capacity with less cash flow available for capital investments. It would quickly become clear to investors and lenders that the regulatory system would permanently prevent the industry from earning its cost of capital. The result, inevitably, would be either deterioration of the US freight railroad network, as occurred during the last period of over-regulation, or a requirement that the government provide billions of dollars in funding for infrastructure, as is the case for most railroads overseas. Either case is likely to lead to inadequate funding of needed infrastructure and a rationing of increasingly scarce capacity that favors traffic with the highest contribution. This will drive lower rated traffic, most of which is highly competitive with motor carriers, onto an increasingly congested highway system. Ironically, it will be the railroad users with less competitive, higher rated traffic who are seeking to change the regulatory structure who will both benefit from lower rates – at the cost of deterioration of the network and/or government subsidies – and who likely will be guaranteed capacity once capacity rationing begins.

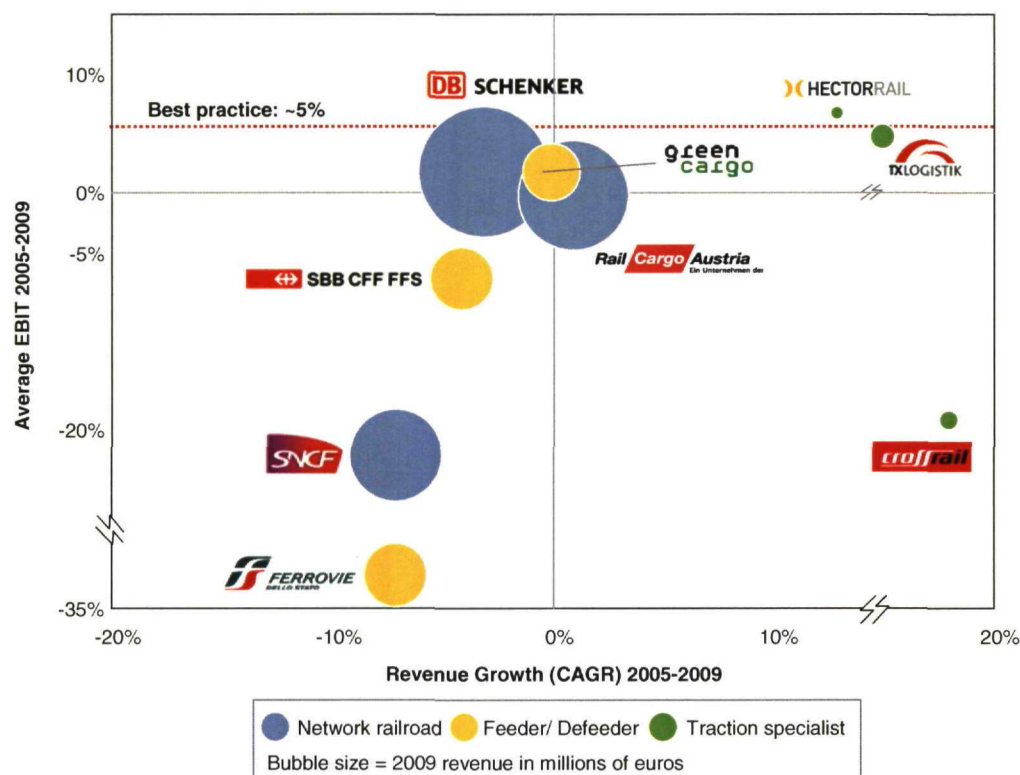
VII. Most international experience should not provide a model for regulation in the United States.

Freight railroad networks outside of North America are fundamentally different from those in the United States. In virtually all cases outside of North America, governments provide and fund railway infrastructure; railroad freight operating companies and passenger railroads pay access charges to use this infrastructure. As shown in Exhibit II-7, freight operating railroads outside of North America pay only a small portion of the government's cost of providing rail infrastructure. This creates a significant indirect subsidy to shippers in those countries, paid by the taxpayers.

Even given this subsidy, neither railroads nor shippers are better off than their counterparts in the United States. For example, in the European Union, multiple above-rail freight operators provide competitive pricing to shippers at virtually all access points for the movement of freight traffic. The result of this policy is that railroad revenues and EBIT are low to negative for most railroads (Exhibit VII-1). Railroads in the lower half of the chart are unprofitable. Even for those that experienced growth, “best practice” earnings were only 5 percent. The largest rail companies continue to show the poorest results, with only small traction providers (with little to no overhead) seeing appreciable returns.

The irony is that the European system, which is designed to foster competitive railroad service at rates subsidized by taxpayers, actually costs shippers more than service in the United States (Exhibit II-3 above), due to the inherent institutional complexity, inefficiency, and fragmentation of the European system of forced access.

Exhibit VII-1: Financial Comparison of European Railroad Companies, 2005-2009



Source: Annual reports, company information, Oliver Wyman database.

Proposals to change current STB policy would disregard the current commercial characteristics of the US rail network, and similar to the European system of forced access, impose competitive pricing access at points where single-carrier service now permits rail carriers to utilize a full range of Ramsey pricing options. Such a policy shift would not only reduce or nullify US railroads' ability to fund infrastructure from cash flows, it would erode the franchise value of the railroads in the eyes of investors, constraining access to the capital markets. In such a case, the question would then be whether the US government is prepared to take on the same

responsibility for infrastructure funding as its European counterparts: this would amount to the US government and by extension taxpayers funding as much as \$150 billion to \$200 billion of required capital investment over the next 25 to 30 years.

The situation in Mexico is similar to that in the United States and Canada, in that railroads largely operate over exclusive networks. When the Mexican national railroad was privatized as three vertically integrated freight railroads, trackage rights and reciprocal switching requirements were limited by design. As one who was involved in the development of Mexico's privatized railroad network, I can testify that the primary purpose of these trackage rights was to preserve economies of scale by not breaking major traffic flows. Reciprocal switching and other access regimes in Mexico play a minor part in the Mexican system. In addition, these requirements were known to investors *before* they invested, and have remained unchanged.

As a result, private investors paid a substantial premium to buy the three railroads and have invested millions of dollars since in infrastructure improvements. According to Mexico's Transportation Secretary, the investments accomplished by the three trunk concessionaires in the first five years of private operations were 30 percent higher than the US\$1.25 billion committed to in their concession contracts.⁸ Since privatization, Grupo Ferrovial Mexicano has invested \$1.7 billion since it assumed operational control in February 1998 and Kansas City Southern de Mexico has invested approximately \$1.9 billion during the same period.⁹ In addition, post-privatization, the Mexican railroads operate with no subsidy for freight operations.

VIII. No matter how they are structured, changes to the current STB position governing competitive access would necessarily reduce the ability of the railroads to maintain the best-in-class US rail network and would impose substantial new costs on taxpayers. Only a small group – primarily those users most dependent on the freight railroad network – would benefit through the creation of a forced access policy

Less than 40 years ago, the US freight railroad network was in tatters. Due largely to a prolonged period of over-regulation of railroad rates and services, all of the major railroads in the Northeast and two large Midwestern railroad systems – the Chicago, Rock Island and Pacific Railroad and the Chicago, Milwaukee, St. Paul and Pacific Railroad – were bankrupt. No railroad was close to earning its cost of capital and the industry was in financial disarray.

The passage of the Staggers Act in 1980 and the decisions of the ICC and then STB in implementing the Act have transformed the US freight railroad system. Today, the US rail system moves more freight, more efficiently, and at a lower cost than any other major railroad system in the world. While most railroads globally consume taxpayer dollars, the US freight railroads require no subsidies and pay taxes. Productivity improvements since 1980 have been passed through to rail customers in the form of lower rates and more efficient service: In inflation-adjusted terms, railroad freight rates have declined by more than 50 percent.

⁸ "La privatización en ferrocarriles en riesgo de desarrillar." *El Economista Mexico D.F.*, February 3, 2004.

⁹ Based on data supplied by UP and Form 8-K for Kansas City Southern de Mexico, S. A. de C.V., January 28, 2008. Exhibit 99-1.

Despite the fact that it does not earn its cost of capital, the railroad industry has provided nearly all of the capital investment necessary to create the efficient, low-cost system its customers enjoy today. To maintain that system and accommodate growth, the US rail industry will need to invest an additional \$150 billion to \$200 billion over the next 25 to 30 years. To do so, it will need to generate growing cash flows and maintain access to capital markets at sustainable rates. This will require, among other things, a stable regulatory environment that does not further reduce the railroad industry's ability to generate sufficient cash flow or earn its cost of capital.

Some parties are urging the STB to change its competitive access policy and implement a policy of forced access. While the proposals have various structures, their purpose is uniformly to reduce railroad revenues. Were these proposals to be adopted, then either the freight network would deteriorate as it did prior to passage of the Staggers Act or taxpayers would be required to provide substantial subsidies for railroad infrastructure, as happens overseas. More likely, both of these outcomes would occur. Given competing demands for transportation infrastructure funds for highways, waterways, mass transit, and rail passenger service, it is not at all certain that sufficient funds would be available to avoid deterioration of the freight rail network. The likely result would be capacity constraints that would lead the railroads to ration scarce capacity in a way that favors shipments with relatively high contribution. This would drive less compensatory traffic onto the publically funded, congested highway system. The only beneficiaries of these proposed changes would be a small group of railroad customers, who would receive an indirect subsidy from US taxpayers, but who at the same time would be assured that their traffic would continue to move over the capacity-constrained rail network.

The fundamental test for any change in STB rail regulatory policy needs to be this: "Will it support continued investment in critically needed capacity growth?" If it fails to do so, the nation's vital freight transportation system, and the economy it supports, will suffer.

As the Christensen study cited earlier concluded, *"Because the railroad industry has remained approximately revenue sufficient in recent years, we reemphasize one of our original conclusions: providing significant rate relief to some shippers will likely result in rate increases for other shippers or threaten railroad financial viability."*¹⁰ The current proposed changes in competitive access are clearly a redistribution of wealth from the railroads to the users of rail. Since there will be no government recapture of price reduction benefits, the pricing changes will in essence "leak" from the current privately funded rail network. The only means of redress for this leak will be either increased public funding to stop the deterioration of the rail network, or the rationing of rail resources that are incapable of meeting all of projected increased demand. If rationing occurs, not only will there be a transfer of wealth from the railroads, but also from the shippers of lower-rated traffic that will have to be cut from the system.

¹⁰ "An Update to the Study of Competition in the US Freight Railroad Industry," Laurits R. Christensen Associates Inc., January 2010, p. iii.

VERIFICATION

I, William J. Rennie, declare under penalty of perjury, that the foregoing statement is true and correct and that I am qualified and authorized to file this statement.

Executed: April 16 2011

A handwritten signature in black ink, appearing to read 'William J. Rennie', is written over a horizontal line.

William J. Rennie

**VERIFIED STATEMENT OF
ROBERT D. WILLIG**

Before the
Surface Transportation Board

**Docket Number EP 705:
Competition in the Rail Industry**

Statement of

**Robert Willig
Professor of Economics and Public Affairs
Princeton University**

April 12, 2011

I. Witness Introduction

A. Qualifications

My name is Robert Willig. I am Professor of Economics and Public Affairs in the Economics Department and the Woodrow Wilson School of Public and International Affairs of Princeton University. I also serve as a senior consultant to the economics consulting firm Compass Lexecon.

I have done extensive research and economic analysis of the railroad industry over the course of my career.¹ I have also testified before the Surface Transportation Board ("STB"), and its predecessor, the Interstate Commerce Commission ("ICC") about issues affecting the rail industry on many occasions.

In general, my academic area of focus for teaching and research is microeconomics, with particular specialization in the field of industrial organization, including competition and regulatory policy. I have extensive experience analyzing such economic issues arising under the law. While on leave from Princeton, I served as Deputy Assistant Attorney General in the Antitrust Division of the United States Department of Justice, and in that capacity served as the Division's Chief Economist. I have consulted to international public agencies, national governments, private companies and law firms, and appeared as an expert witness before Congress, federal and state courts, federal administrative agencies, and state public utility commissions on subjects

¹ See, for example, "Competitive Rail Regulation Rules: Should Price Ceilings Constrain Final Products or Inputs?" (with W. J. Baumol): *Journal of Transport Economics and Policy*, vol. 33, part 1, pp. 43-53; "Restructuring Regulation of the Rail Industry." (with Ioannis Kessides), in *Private Sector*, Quarterly No. 4, September 1995, pp. 5 – 8; "Competition and Regulation in the Railroad Industry." (with Ioannis Kessides), in *Regulatory Policies and Reform: A Comparative Perspective*, C. Frischtak (ed.), World Bank, 1996; "Railroad Deregulation: Using Competition as a Guide." (with W. Baumol), *Regulation*, January/February 1987, vol. 11, no. 1, pp. 28-35; "Pricing Issues in the Deregulation of Railroad Rates" (with W. Baumol), in *Economic Analysis of Regulated Markets: European and U. S. Perspectives*, J. Finsinger (ed.), 1983.

involving microeconomics, competition, and regulation in a wide variety of sectors including transportation and railroading specifically.

I have been asked by the AAR to provide comments on various issues related to competition in the rail industry. Specifically, I have been asked to comment, from the perspective of economics, on the reasonableness of the Board's current approach to resolving competitive issues and to discuss the economic implications of moving away from the current rules.

I will start with a brief overview of the basic principles of economic regulation, with a particular focus on the public interest rationale for price regulation. I will then move into a discussion of the current state of competition in transportation markets in which freight railroads participate. That will be followed by an analysis of the effectiveness of the Board's current competitive access rules in addressing competitive problems. Before concluding my remarks, I will address the economic implications of abandoning the current access rules, resulting in a more restrictive system of rate regulation that would not be guided by the basic economic principles of competitive markets.

II. Basic Principles of Economic Regulation.

A. Where competition exists, the public's interest is served by allowing the competitive conditions of supply and demand to set price and influence investment decisions.

There is no dispute that the public's interest in the efficient allocation of an economy's scarce resources is best served by reliance on well-functioning market forces. Prices that are set in properly functioning markets, as the result of the interplay of supply

and demand, serve the important function of allocating resources to where they are most needed in the economy, and motivating the needed supplies. In the rail sector, where a need for increased capacity is projected, it is particularly important that the market forces signal the appropriate level of investment.

Regulatory interference with these elements of the competitive process, even if well-intended by policy-makers, can cause systematic economic problems and counterpart social harms. Policies that block this process by artificially holding prices down in otherwise competitive markets invariably discourage supply that is genuinely needed, while over-encouraging demand relative to supply. In the rail sector, the risk posed by intrusive regulation that alters prices from market levels is that railroads will not make the investments that shippers and their customers in the affected transportation market desire and need.

Indeed, for the rail sector, history provides a powerful example of the dangers of intrusive regulation. The slow deterioration of rail infrastructure and service quality that eventually led to the passage of the Staggers Act, with its emphasis on allowing market forces to establish prices whenever possible, was the direct result of years of misguided regulatory intervention. Staggers' focus on allowing, to the largest extent possible, the transportation market to set prices that are an accurate reflection of shippers' levels of willingness-to-pay for, and railroads' willingness to provide, the relevant services led to increased investment where it was economically sensible, reduced investment where it was not, and allowed railroads the freedom to determine the efficient size and configuration of their networks based on market demand. Shipper demands for rail transportation services - reflected in the prices shippers are willing to pay - should

continue to provide the information that railroads need to determine the right size of their networks as they have in the thirty years since Staggers.

B. Where competition is absent, regulation may be necessary to serve the public's interest.

Economics teaches that where there is no competition in a market due to the costly nature of alternative sources of supply and due as well to high barriers to entry, market forces cannot be relied upon to yield prices that are conducive to economic efficiency and the public interest. In these cases – where competition is absent, and is expected to remain absent due to underlying conditions of costs and entry barriers – some degree of regulation may be warranted to control prices, prevent or remedy abuses of market power, and encourage the provision of additional supply.

However, it is important to be clear. That a market does not include a second railroad is not a sign of market failure. In some markets, entry of a second railroad may be neither efficient nor economically viable. The absence of a second railroad does not by itself warrant regulatory intervention. Regulatory intervention is not necessary or appropriate unless the absence of competition has produced outcomes that are inconsistent with the public interest.

In the railroad industry, regulators have identified two basic circumstances under which regulatory intervention may be needed: (1) where the existence of entry barriers allows market dominant railroads to set unreasonably high prices and (2) where there is an abuse of market power through monopolistic anticompetitive foreclosure, price squeeze, or predatory behavior. Where the concern is that entry barriers have led to high prices, regulatory intervention is available through regulation of rates. Where the

concern is that a railroad has abused its market power with anticompetitive behavior, then regulatory intervention is available through access remedies. However, under both circumstances, regulators should attempt to provide market participants with the same signals that a well-functioning market would provide. Properly crafted regulation would correct market failures without disrupting market-based incentives for railroads to make capital investments, expand capacity to handle expected volumes, and generally make economically efficient choices about the configuration of their networks and the service provided.

C. The Board’s current approach to regulation is appropriate and effective.

For purposes of rate regulation, the ICC and STB have adopted regulatory rules intended to elicit outcomes consistent with a properly functioning market. The rules related to rate regulation, commonly referred to as “Constrained Market Pricing” (“CMP”), were designed specifically to rely on competitive market principles to promote public-interest pricing. The essential “constraint” of CMP, and the one to which I refer in this statement, is a rate ceiling set at a Stand Alone Cost (“SAC”) level.

In analyzing the essential elements of SAC, it is important to begin with an understanding of when it is appropriate to invoke SAC-based regulation. Because SAC is efficiently focused on eliciting competitive or contestable market outcomes,² it is only appropriate to consider regulating based on SAC in cases where there has been a showing of the absence of market forces that themselves bring about efficient competitive or

² In competitive or contestable markets, a railroad would be unable to charge more than what it would cost a new entrant to supply the service in question on a stand-alone basis. Charges above SAC would lose the shipper’s business to competitive entry or expansion – either from competitors in the same industry, from competitors offering alternative geographic options, or from competitors offering substitute products, for example.

contestable outcomes. Thus, a demonstration of market dominance is an appropriate precondition for the application of SAC-based rate regulation.³ To do otherwise – to regulate rates in situations where there has not been a showing of inadequate market forces – would be to impose regulation on a market that has displayed no evidence of market failures. Such regulation is itself apt to harm social welfare, despite the best of intentions of the regulators, because it would be interfering with the efficient operations of market forces and likely resulting instead in outcomes that are inefficiently distorted by regulation.

One of the key features of SAC-based rate regulation is that it allows railroads to decide how to price their services within a range with a SAC ceiling and a floor of incremental costs. The ceiling ensures that shippers will pay no more than what they would in a competitive or contestable market where a railroad would be able to charge no more than what it would cost a new entrant to supply the service in question on a stand-alone basis. Conversely, the rate floor mirrors the minimum price that would be supported in a competitive or contestable market because there firms are unable to sustain prices that do not cover at least the costs that a service causes them efficiently to incur.

Mandated access, by which I mean requiring a railroad to provide access to its terminals, or reciprocal switching, or to interchange with another railroad at a point not chosen by the railroads, addresses issues separate from rate regulation, and I understand that the Board has properly established a separate and appropriately higher standard for such a remedy to ensure that it is not just a substitute for rate regulation. The ICC and

³ Thus, it is my understanding that the law prohibits the Board from even inquiring about the reasonableness of a rate unless the rate exceeds the 180 percent revenue-to-variable cost threshold. I understand that the law also requires the Board to find an absence of effective competition (although the absence of competition under current rules is limited to only intermodal and intramodal competition).

STB have used their authority in a judicious manner, requiring a demonstration of abusive conduct by the incumbent railroad – not just an absence of another railroad – before mandated access is granted.

Although SAC is applicable only to rate regulation, the principles at the heart of SAC are also at the heart of the standards applied to questions of mandated access. First, as with SAC, the role for regulation is appropriately limited to situations where there has been a definitive showing of the absence of market forces sufficient to produce efficient, effectively competitive, outcomes. Second, if regulatory intervention is warranted, the ability of railroads to price differentially must be preserved. The fundamental objective in regulation of rates and regulation of access is to allow incumbent railroads to price in accord with market demand in a manner that promotes the recovery of full economic costs, including the costs of capital. Preserving the ability of railroads to price differentially and recover full costs must govern any policies adopted for handling issues of mandated access.⁴

However, unlike in a SAC case, the higher requirement in mandated access cases for a showing of abusive conduct inconsistent with effective competition – as opposed to just a showing of the absence of head-to-head rail competition or other forms of effective competition – is appropriate and, in fact, essential. It does not follow that a market outcome is anticompetitive just because there are few, if any, competitors in the market. Especially in the railroad industry, the presence of only one railroad in a market often reflects the efficient operation of market forces, not a market failure. That is because business levels and revenue often warrant participation by no more than one railroad in

⁴ It is important for the Board to avoid falling into the trap of thinking that SAC-based rates would be appropriate on “bottleneck” rail segments if shippers were allowed to access a second railroad by forcing an interchange. As discussed further below, they would not be.

any particular transportation market. Such market outcomes are not anticompetitive – and do not warrant intervention – unless they are the result of the single railroad engaging in abusive conduct to maintain its position. Where a single-seller has not attained or maintained its position through anticompetitive acts, regulatory intervention that would mandate access for a second seller invites complainants to request, and to be granted, relief that results in an outcome that is neither market-based nor otherwise in the public interest.⁵ Even if the access is appropriately priced – which raises potentially complicated issues – the insertion of a second railroad also introduces inefficiencies into the system by disrupting existing operations, raising costs, and reducing economies of scale and scope. Requiring a showing of abusive conduct is the only way to ensure that regulation intervenes only when markets have actually failed, and not just where competitors or customers would like additional options.

Moreover, even when competitive access is appropriately granted as a remedy, that access must be priced with reference to prices that would prevail on through movements from the origin to destination, without regard to the financial health of the transportation service provider. In other words, the mandated introduction of a second railroad cannot be allowed to undermine the incumbent's viability by depriving it of the benefit of differential pricing. As I discuss in more detail in Section IV.B, "efficient component pricing" satisfies this requirement. "Efficient component pricing" holds that when a landlord railroad provides access to another railroad, the landlord railroad is entitled to realize at least the same contribution that it receives for selling the service on the through movement, ensuring that landlord railroads are able to cover their extensive

⁵ For the purposes of this statement, I define market-based outcomes as outcomes that are consistent with the types of competitive and contestable markets outlined in footnote 2, above.

fixed costs, including the direct costs of providing access and any indirect costs such as loss of efficiencies at other points on their network. It is important not to confuse “efficient component pricing,” which focuses on contribution from the through movement, with applying the SAC constraint to the bottleneck segment, or to the terminal or switching service through which access is achieved. As discussed below, applying SAC only to a bottleneck segment, or to a terminal or switching service, would deprive the landlord railroad of revenues necessary to ensure the financial viability of the railroad over the long term.

The current competitive access rules, and the STB’s application of those rules, are sound. Proposals to move away from the current regulatory approach require advocating regulatory intervention in situations where there is no demonstrable competitive abuse. Unnecessarily injecting a second competitor into a market where there has been no showing of competitive abuse would serve only to raise complex questions regarding access pricing and reduce the efficiency of existing operations.

III. Competition in the Surface Transportation Markets in which Freight Railroads Participate Is Widespread.

A. Numerous indicators of rail industry performance are consistent with an industry that is responding rationally and efficiently to competitive market forces.

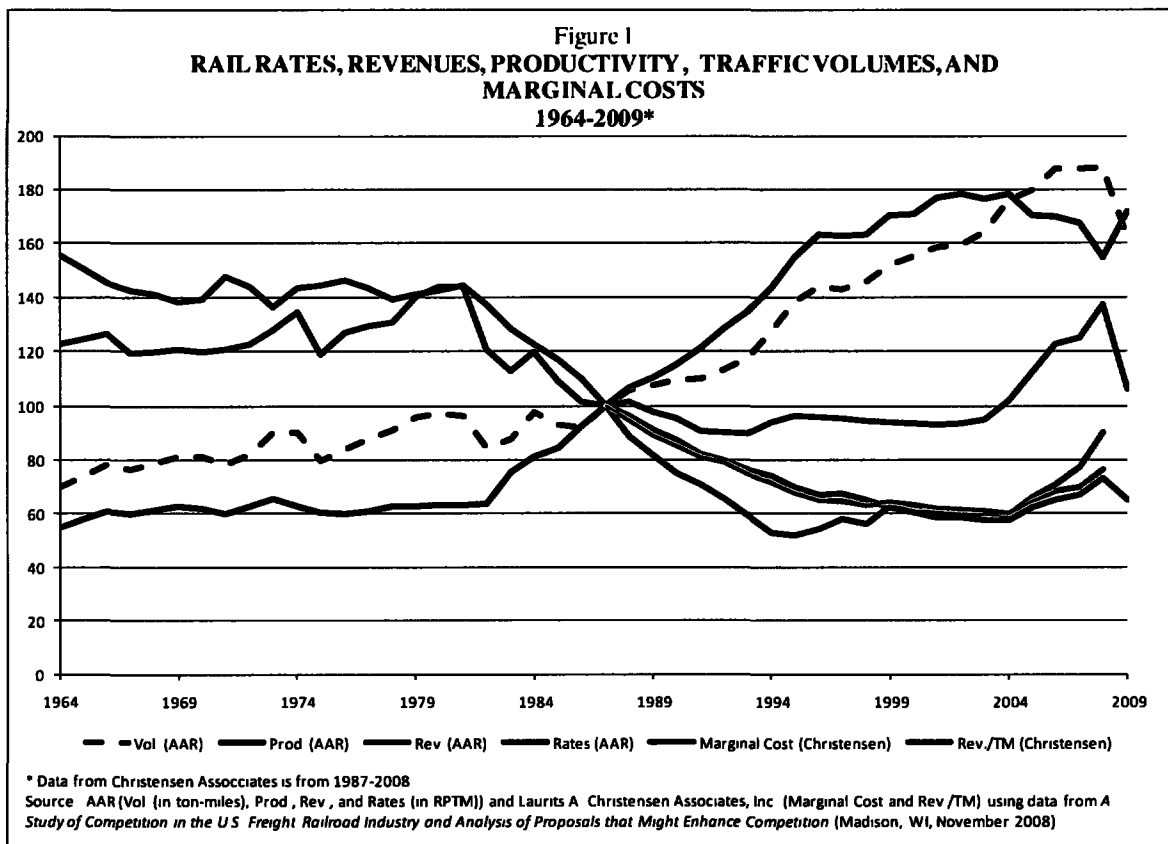
In the thirty years since the passage of the Staggers Act, the rail industry has been transformed from an industry on the brink of failure to a serious competitor in transportation markets. Much of this transformation is due to the competitive principles at the heart of the Staggers Act. These principles allowed railroads to price based on demand for services, freed railroads from maintaining and operating lines under

regulatory mandate, and opened the door for numerous transactions that have allowed the industry to reorganize and rationalize the nation's rail network in response to forward-looking conditions and needs of the marketplace.

In exercising their authority under Staggers, the ICC and STB have been vigilant about protecting the public's interest in the preservation of competition by allowing markets to govern themselves where feasible and by intervening only in targeted areas where the evidence demonstrates a market failure. The results have been dramatic, and are fully consistent with an industry operating under generally competitive conditions.

As shown in Figure 1, below, standard measures of rail performance, including rates, productivity, revenues, and volume have shown consistent improvement since the inception of the Staggers Act.⁶ The post-Staggers period is perhaps most notable for remarkable, decades-long improvements in productivity and the simultaneous sustained growth in rail volumes. Although prices have showed some firming in recent years, that is not an indicator of inadequate competition. Rather, it is reflective of healthy markets responding appropriately to the combination of rising costs and strained capacity.

⁶ Figure 1 is reproduced from my previous testimony in EP 704.



The measure of marginal cost reported in Figure 1 is from the Christensen and Associates analysis of competition in the US freight rail industry ("Christensen Study").⁷ As the figure shows, marginal costs increased sharply beginning in 2003, an increase Christensen attributes largely to fuel cost increases.⁸ The Christensen Study concludes that price increases in the face of increasing marginal costs are not indicative of an abuse of market power. I agree. Rather, they are entirely consistent with – and expected in – competitive markets.

There is nothing in these data to suggest that there has been a general outbreak of

⁷ Laurits A. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals that Might Enhance Competition, Revised Final Report*, (Madison, WI, November 2009) (hereafter, "Christensen Rail Study - 2009") Christensen and Associates issued an update to their initial study in January 2010: Laurits A. Christensen Associates, Inc., *An Update to the Study of Competition in the U.S. Freight Railroad Industry, Final Report* (Madison, WI, January 2010) (hereafter "Christensen Rail Study – Updated 2010")

⁸ Christensen Rail Study – Updated 2010 at 3-24. The study notes fuel cost increases of more than 200% between 2003 and 2008, resulting in a 28 percent increase in marginal costs over the same period.

market power abuses or a diminution of competition in the rail industry overall. The essence of the abuse of market power is the withholding of supply to drive up price but we see exactly the opposite pattern in Figure 1: the upticks we see in rail rates starting in 2003-04 occurred during a period of rapidly *growing* overall traffic volumes. In addition, during this period there were other constraints affecting transportation markets, such as constrained highway capacity, truck driver shortages, changes in the cost structure of trucking due to new government rules on emissions and driver rest.⁹ This strong growth persisted through to the onset of recession in 2008; and the slowing of growth due to the recession has now begun to soften rail rates.

The very strong demand that is reflected in the steady and steep rise in overall traffic volumes in the post-Staggers era strained capacity in the rail sector¹⁰ – and upward pressure on prices is precisely the expected outcome in effectively competitive and contestable markets that run into congestion and limitations of capacity. While it may be the case that individual shippers have specific and limited concerns with an individual railroad over an individual route, there is no evidence indicating any systemic abuse of market power or widespread anticompetitive behavior in the industry. Thus, the Board's current regulatory approach – favoring targeted regulatory intervention to address specific competitive concerns, instead of broad-brush, blanket regulation – is the economically reasonable approach.

⁹ Ortiz, David S., et. al, "Increasing the Capacity of Freight Transportation: U.S. and Canadian Perspectives," RAND Infrastructure, Safety, and Environment, 2007, available at http://www.rand.org/content/dam/rand/pubs/conf/proceedings/2007/RAND_CF228.pdf, accessed January 26, 2011 (hereafter, "RAND Freight Study") at 13-14.

¹⁰ Congressional Budget Office, "Freight Rail Transportation: Long Term Issues", (hereafter, "CBO Freight Rail Report") January 2006, at 1: "After a long period of excess rail capacity, the pendulum has begun to swing toward tight capacity—at least at certain times and places." See also, Weatherford, Brian A. Henry Wills, and David S. Ortiz, "The State of US Railroads: A Review of Capacity and Performance Data," RAND Supply Chain Policy Center, 2008 (hereafter, "RAND Rail Study") at 3, noting that over the past 25 years traffic density on the nation's rail network has "nearly tripled."

B. The agency-endorsed adoption of differential pricing in the rail industry has fulfilled the congressional objective of allowing competition and the demand for service to establish reasonable rail rates to the maximum extent possible while also providing the vehicle for full cost recovery.

Congress, the ICC and the STB have all recognized that rail carriers face a broad range of competition for their services in the many different markets in which they operate.¹¹ These varying competitive circumstances range from intense intra- and intermodal competition (frequently including via transloading options) and competition from substitute products or sources of supply to situations in which rail carriers are market dominant. These varying circumstances require varying levels of regulatory attention.

The existing regulatory regime gives rail carriers the freedom to price their services in response to shipper demand and to recover differing amounts of unattributable costs from different shippers, depending on their elasticity of demand.¹² In high fixed costs industries like rail, this differential pricing ability is a critical element in making progress toward full cost recovery. Thus, the Board should reject any suggestion that the improved financial condition of railroads justifies dispensing with differential pricing.

However, the existing regulatory scheme also recognizes limits on this pricing freedom as embodied in SAC and consistent with competitive markets. Given the cost structure of the rail industry, the differential pricing approach is the most economically efficient approach available and the one that makes most effective use of competitive market forces.

¹¹ See, for example, Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985) at 522; Rate Guidelines – Non Coal, 1 S.T.B. at 1007.

¹² Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985) at 526-527.

The concept underlying differential pricing – that railroads must be allowed to charge prices consistent with market demand in order to cover their costs -- is clearly relevant to questions of mandated access. Mandated access cannot become just another way to get rate relief, either by substituting a new railroad for the through movement over the incumbent's lines, or by requiring an incumbent carrier to interchange traffic on the non-bottleneck portion of the incumbent's through movement. Moreover, as discussed earlier, even when mandated access is an appropriate remedy for anticompetitive behavior, access prices must be established using efficient component pricing principles to preserve differential pricing. Claims for access at prices below efficient component prices are properly viewed as an attack on differential pricing and should be rejected.

IV. The Board's Existing Competitive Access Rules Reflect the Correct Approach to Alleviating Competitive Problems.

A. The STB has reasonably applied the existing competitive access rules.

The STB's existing competitive access rules are specifically targeted at addressing *abuses* of market power. They are not rate remedies, nor do they remedy situations where there is just a lack of competitive alternatives. Rather, because the remedies are so intrusive and so inimical to competition, they are intended to be used in the unique and limited instances when railroads abuse market power and engage in conduct that is anticompetitively exclusionary. The Board's existing rules properly recognize that they are not and should not be simply an alternative to rate regulation under SAC.

The Board is currently guided by competitive access rules that are articulated in

the ICC decision on Ex Parte 445 (Sub-No.1): Intramodal Rail Competition. This decision addresses "...various issues generally referred to as 'competitive access,' including cancellation of joint rates and through routes, and the prescription of joint rates, through routes, and reciprocal switching."¹³

These rules have been applied in several cases. Those cases offer insight into the ICC's and STB's view of the elements that must be present to justify mandated access. In the Midtec Paper case, the ICC found there was not sufficient evidence to warrant the imposition of reciprocal switching or terminal access. In explaining the ruling, the ICC stated:

"...we were attentive to the possibility of classical categories of competitive abuse: foreclosure; refusal to deal; price squeeze; or any other recognizable forms of monopolization or predation. We also considered whether there was any evidence of abuses under the competitive standards of the Rail Transportation Policy, including inadequate service or excessive prices. Under either approach, we found none."¹⁴

The decision continues with discussion of the difference between correcting competitive abuses and protecting the interests of an individual shipper, stating:

"But since we do not find evidence of abuse, we are left with complainant Midtec's argument that it would benefit from the mandatory addition of a second railroad..."¹⁵ "Reduced to a desire for the service of a second carrier, complainants' plea is one of wide applicability. While the Staggers Act incorporated new emphasis on the importance of intramodal competition, we think it correct to view the Staggers changes as directed to situations where some competitive failure occurs. There is a vast difference between using the Commission's regulatory power to correct

¹³ Intramodal Competition. 1 ICC 2d 822 at 822.

¹⁴ Midtec Paper Corporation, et al v. Chicago and North Western Transportation Company (Use of Terminal Facilities and Reciprocal Switching Agreement), ICC Docket No. 39021, Decided December 2, 1986 (hereafter, "Midtec") at 173-174.

¹⁵ Midtec at 174.

abuses that result from insufficient intramodal competition and using that power to initiate an open-ended restructuring of service to and within terminal areas solely to introduce additional carrier service.”¹⁶

Most recently, the STB articulated an approach to mandated access in its decision in the Entergy case. Of particular relevance here, the STB denied Entergy’s request to create a new BNSF-MNA joint route from the Southern PRB to a plant located on a line leased by UP to MNA because Entergy had not shown evidence of “competitive abuse” and further because the existing UP-MNA route is “more efficient (‘better’)” than the alternative routing requested by Entergy.¹⁷

B. The current competitive access rules are an effective and appropriate approach to regulatory oversight.

In the January 11 Notice, the STB solicited comment on the current state of competition, with particular attention on whether a change to the competitive access rules and the current approach to bottleneck pricing regulation are warranted. I have seen no evidence to suggest a change in policy is necessary or appropriate. As discussed above, the current competitive access rules properly prescribe access in situations where there has been demonstrable competitive abuse – monopolistic anticompetitive foreclosure, refusal to deal, price squeezes, or predatory behavior – and provide the STB with the tools necessary to identify when individual circumstances warrant intervention.

Notably absent from the list of competitive concerns is a requirement to achieve a specific number of competitors; to consider what is most convenient for or beneficial to a

¹⁶ Midtec at 174.

¹⁷ Entergy Arkansas, Inc. & Entergy Services, Inc. v. Union Pacific Railroad Company, Missouri & Northern Arkansas Railroad Company, Inc. & BNSF Railway Company, Docket No. 42104; Missouri & Northern Arkansas Railroad Company, Inc.- Lease, Acquisition and Operation Exemption – Missouri Pacific Railroad Company and Burlington Northern Railroad Company, Docket No. FD 32187, Decision, March 15, 2011, at 8.

specific customer or set of customers; or to advance the interests of individual competitors. The current competitive access rules are not – nor should they be – concerned primarily with advancing the business interests of individual market participants, but instead are focused on ensuring efficient market-based outcomes. They are built around the proposition that markets should be allowed to function without regulatory intervention whenever possible and that mandated access is only warranted upon a supported showing of anticompetitive abuse. Proposals to change access rules on a basis other than a determination of anticompetitive abuse are misguided.

A market where there is no evidence of abusive conduct and where there are also no competitive rail alternatives available to shippers may well indicate that there is no efficient role for a competitor. If there were an efficient competitive alternative, the market would either support two independent facilities *or* the incumbent railroad, recognizing the efficiency of a competitive entrant, would have incentives to agree to a negotiated access agreement. Therefore, in markets where there is only one participant and no competitive concern, regulator-imposed access coercively mandates arrangements for sharing facilities that are not sufficiently efficient to have emerged from market forces. Only in the limited instances where there is evidence of abusive anticompetitive conduct is there a role for regulation. However, it is essential that regulators not confuse competitive failures stemming from abusive conduct with self-serving applicants seeking individually beneficial but inefficient, welfare-harming outcomes that are not consistent with effective competition.

While I have focused on competitive access regulation to this point, the idea that regulatory intervention in areas that show no evidence of abuse of market power damages

the overall health of the rail industry is widely applicable to other issues identified by the Board in its notice in this matter, most notably bottleneck pricing issues. Current policy regarding bottleneck pricing is appropriately focused on the full, origin-to-destination (“O-D”) move. Often, discussions on bottleneck pricing lead to proposals by some parties that the pricing of bottleneck services should be subject to the same pricing rules that are applied to the pricing of final products. For example, it is proposed by some that pricing of a bottleneck segment should not exceed replacement (or stand-alone) cost of the bottleneck facility. Focus on the prices of components of the final product rather than the price of the full O-D route is misguided and would preclude the financial viability of the railroad. Consider the implications of a regulatory policy that allows bottleneck services to generate only enough revenue to cover the replacement costs of the bottleneck service: because pricing on the competitive portion of the route is pushed toward incremental costs, it follows that there would be no source of revenue to cover the fixed costs of the competitive portion. Without the ability to cover their full costs, railroads will not be able to attract capital and make long-term investments in infrastructure and equipment. Without these investments, railroads will not be able to achieve cost-reducing (or even cost-maintaining) efficiencies, leading to service deterioration and to increasing variable costs. Increasing variable costs will put upward pressure on prices, pricing some shippers off of railroads entirely, thus reducing overall revenues and beginning the spiral into financial insolvency that was so familiar in the pre-Staggers era. Shipper demand is manifested in what the shipper is willing to pay for the through service, and not for a segment of the through movement. Thus, the relevant price is the price of the final product, i.e., the O-D route.

Where there are no legitimate concerns about competition with regard to the final product pricing, but regulation were nevertheless introduced in a fashion that pushed the final product prices lower – through the introduction of additional supply (mandated access, for example) or the imposition of a price ceiling (regulating rates on bottleneck segments, for example) - those prices are then below competitive prices. Below-competitive pricing means that railroads' revenues will be artificially suppressed – an unsustainable condition that does not send the right signals about what railroads need to supply to optimize social well-being and that will, over the long run, impede investment, maintenance, and normal operations and lead to the overall deterioration of the rail network.

V. Efforts to Enhance Competition by Regulatory Fiat Will Not Yield the Same Social Benefits as Unfettered Market Forces and May Result in Economic Inefficiency and Disinvestment.

There is no dispute that outcomes from well-functioning market forces are in the public interest. Such market-based prices are important signals for attracting investment; motivating efficient entry, exit and capacity expansions; and generally deploying resources efficiently. The current STB approach embodies this idea. Changes in competitive access rules that are divorced from economic logic, that elevate regulatory judgment over market forces, and that are motivated by self-interested requests from various parties would install inefficient competitors and create poor incentives for investment in the national rail network. These poor incentives lead to inefficient resource allocation, resulting in stalled capacity expansions, general disinvestment, and the eventual deterioration of infrastructure and service quality.

It is not necessary to rely only on economic theory to understand the calamitous consequences of coerced access and irrational regulatory policy. The history of the rail industry before Staggers is instructive in this regard. Pre-Staggers regulation, which consisted of rigid price-setting formulas; general rate increases; regulation of the minimum level of rates; and mandated service, structure and operating practices, led to deteriorating equipment and systems, frustrated shippers, and eventually disinvestment, declining quality, and failed railroads.

At one point, the ICC, in its pre-Staggers role, was viewed as “a giant handicapper.”¹⁸ Rather than regulating based on economic criteria and establishing rules that aimed to achieve efficient, market-based outcomes, the ICC’s pre-Staggers approach was to impose regulations that ensured that no transportation mode threatened the existence of any other mode. Railroads were forced to maintain inefficient, unprofitable service; on efficient routes they were required to price service at rates too low to allow them to recover the full cost of service; and the system of rate floors and ceilings created few incentives for investment and productivity enhancements.¹⁹ The result was disastrous. Railroads could not attract investment, infrastructure and equipment deteriorated, and many railroads fell into bankruptcy.

The Staggers Act re-focused rail regulation on economic principles, advocating the primacy of market forces over regulation whenever possible, and adhering to basic economic principles when regulation is necessary. The result is a revitalized railroad industry today that largely relies on competitive markets to dictate pricing, entry, and exit

¹⁸ For a discussion of the origins of the “giant handicapper” characterization, see: Baumol, William J. and Alfred G. Walton, “Full Costing, Competition and Regulatory Practice” *The Yale Law Journal*, Vol. 82, No. 4 (Mar., 1973), pp. 639-655, at 646.

¹⁹ Willig, Robert D., and William J. Baumol, “*Using Competition as a Guide*,” *Regulation*, 1987, Number 1, at 30-32.

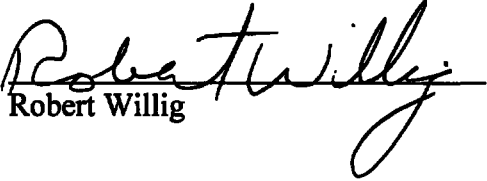
decisions. Moving away from the sound, economically rational regulatory framework currently applied by the STB in favor of mandating access in a variety of ways would be equivalent to the pre-Staggers system of mandating specific routes and levels of service without regard to economic reasoning. There is no need – nor is there any economic justification – to change the current regulatory approach. There is, however, clear evidence that abandoning the current approach in favor of unnecessary and unreasonable regulation will cause truly dangerous long-term harms to the rail network. Reverting to regulation that is not grounded in sound economics will lead us back to the dilapidated state in which we found the industry before Staggers.

This analysis points to a clear regulatory approach. In the limited instances where there are demonstrable market failures, the fall-back position must be regulation that is grounded in market-based principles. Those principles are embodied in SAC in the context of rate cases, and efficient component pricing, in the context of mandated access. Regulating in a way that is inconsistent with these principles would be a mistake.

VERIFICATION

I, Robert Willig, declare under penalty of perjury, that the foregoing statement is true and correct and that I am qualified and authorized to file this statement.

Executed: April 8, 2011


Robert Willig